

STERLING FINANCIAL CORP /WA/

Form 10-K

March 15, 2006

**Table of Contents**

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

**(Mark One)**

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**

**For the year ended DECEMBER 31, 2005**

**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  
(IRS Employer Identification No.)

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

Registrant's telephone number, including area code: (509) 458-3711  
Securities registered pursuant to Section 12(b) of the Act:

None  
(Title of each class)

None  
(Name of each exchange on which registered)

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

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes  No

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or 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

As of June 30, 2005, the aggregate market value of the common equity held by non-affiliates of the registrant, computed by reference to the average of the bid and asked prices on such date as reported by The NASDAQ National

Market, was \$863,352,820.

The number of shares outstanding of the registrant's common stock, par value \$1.00 per share, as of January 31, 2006 was 34,889,044.

DOCUMENTS INCORPORATED BY REFERENCE

Specific portions of the registrant's Proxy Statement dated March 24, 2006, are incorporated by reference into Part III hereof.

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**STERLING FINANCIAL CORPORATION  
DECEMBER 31, 2005 ANNUAL REPORT ON FORM 10-K  
TABLE OF CONTENTS**

|                        |  | Page |
|------------------------|--|------|
| <b><u>PART I</u></b>   |  | 1    |
| <b><u>Item 1.</u></b>  | <b><u>Business</u></b>   | 1    |
|                        | <u>General</u>   | 1    |
|                        | <u>Company Growth</u>  | 1    |
|                        | <u>Profitability Drivers</u>   | 2    |
|                        | <u>Lending Activities</u>  | 2    |
|                        | <u>Investments and Mortgage-Backed Securities</u>  | 12   |
|                        | <u>Sources of Funds</u>  | 13   |
|                        | <u>Subsidiaries</u>  | 17   |
|                        | <u>Competition</u>   | 18   |
|                        | <u>Personnel</u>   | 18   |
|                        | <u>Environmental Laws</u>  | 18   |
|                        | <u>Regulation</u>  | 19   |
|                        | <u>Forward-Looking Statements</u>  | 25   |
|                        | <u>Where You Can Find More Information</u>   | 25   |
| <b><u>Item 1A.</u></b> | <u>Risk Factors</u>  | 26   |
| <b><u>Item 1B.</u></b> | <u>Unresolved Staff Comments</u>   | 31   |
| <b><u>Item 2.</u></b>  | <b><u>Properties</u></b>   | 31   |
| <b><u>Item 3.</u></b>  | <b><u>Legal Proceedings</u></b>  | 31   |
| <b><u>Item 4.</u></b>  | <b><u>Submission of Matters to a Vote of Security Holders</u></b>  | 31   |
| <b><u>PART II</u></b>  |  | 32   |
| <b><u>Item 5.</u></b>  | <b><u>Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u></b> |      |
|                        | <u>Stock Market and Dividend Information</u>   | 32   |
| <b><u>Item 6.</u></b>  | <b><u>Selected Financial Data</u></b>  | 33   |
| <b><u>Item 7.</u></b>  | <b><u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u></b>                        | 35   |
|                        | <u>Executive Summary and Highlights</u>  | 35   |
|                        | <u>Critical Accounting Policies</u>  | 35   |
|                        | <u>Results of Operations for the Years Ended December 31, 2005 and 2004</u>  | 38   |
|                        | <u>Results of Operations for the Years Ended December 31, 2004 and 2003</u>  | 43   |
|                        | <u>Financial Position</u>  | 45   |
|                        | <u>Asset and Liability Management</u>  | 47   |
|                        | <u>Liquidity and Capital Resources</u>   | 51   |
|                        | <u>Off-Balance Sheet Arrangements and Aggregate Contractual Obligations</u>  | 52   |
|                        | <u>Capital</u>   | 53   |
|                        | <u>Goodwill Litigation</u>   | 53   |
|                        | <u>New Accounting Policies</u>   | 54   |
|                        | <u>Effects of Inflation and Changing Prices</u>  | 54   |
| <b><u>Item 7A.</u></b> | <b><u>Quantitative and Qualitative Disclosures About Market Risk</u></b>   | 54   |
| <b><u>Item 8.</u></b>  | <b><u>Financial Statements and Supplementary Data</u></b>  | 54   |
|                        | <b><u>Changes in and Disagreements with Accountants on Accounting and Financial</u></b>                                    |      |
| <b><u>Item 9.</u></b>  | <b><u>Disclosure</u></b>   | 54   |

|                          |  |    |
|--------------------------|--|----|
| <b><u>Item 9A.</u></b>   | <b><u>Controls and Procedures</u></b>  | 55 |
|                          | <u>Management's Report on Internal Control Over Financial Reporting</u>                                      | 55 |
|                          | <u>Report of Independent Registered Public Accounting Firm</u>   | 55 |
| <b><u>Item 9B.</u></b>   | <b><u>Other Information</u></b>  | 57 |
| <b><u>PART III</u></b>   |  | 57 |
| <b><u>Item 10.</u></b>   | <b><u>Directors and Executive Officers of the Registrant</u></b>   | 57 |
| <b><u>Item 11.</u></b>   | <b><u>Executive Compensation</u></b>   | 57 |
| <b><u>Item 12.</u></b>   | <b><u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u></b> | 57 |
| <b><u>Item 13.</u></b>   | <b><u>Certain Relationships and Related Transactions</u></b>   | 57 |
| <b><u>Item 14.</u></b>   | <b><u>Principal Accounting Fees and Services</u></b>   | 57 |
| <b><u>PART IV</u></b>    |  | 58 |
| <b><u>Item 15.</u></b>   | <b><u>Exhibits, Financial Statement Schedules</u></b>  | 58 |
| <b><u>SIGNATURES</u></b> |  | 59 |
| <u>EXHIBIT 12.1</u>      |  |    |
| <u>EXHIBIT 12.2</u>      |  |    |
| <u>EXHIBIT 21.1</u>      |  |    |
| <u>EXHIBIT 23.1</u>      |  |    |
| <u>EXHIBIT 31.1</u>      |  |    |
| <u>EXHIBIT 31.2</u>      |  |    |
| <u>EXHIBIT 32.1</u>      |  |    |
| <u>EXHIBIT 32.2</u>      |  |    |

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**Table of Contents**

**PART I**

**Item 1. Business**

**General**

Sterling Financial Corporation ( Sterling ) is a bank holding company, the significant operating subsidiary of which is Sterling 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.

Sterling provides personalized, quality financial services to its customers as exemplified by its Hometown Helpful philosophy and Perfect Fit banking products. Sterling believes that this dedication to personalized service has enabled it to grow both its retail deposit base and its loan portfolio in the Pacific Northwest region. With \$7.56 billion in total assets at December 31, 2005, Sterling originates loans and attracts Federal Deposit Insurance Corporation ( FDIC ) insured deposits from the general public through 140 retail branches located in Washington, Oregon, Idaho and Montana. Sterling originates loans through its branch offices, as well as through Action Mortgage residential loan production offices in the four-state area and Utah, and through INTERVEST commercial real estate lending offices in Washington, Oregon, Arizona and California. 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 Pacific Northwest by increasing its commercial real estate, business banking, consumer and construction lending while also increasing its retail deposits, particularly transaction accounts. Commercial real estate, business banking, consumer and construction loans generally produce higher yields than residential loans. Management believes that a community bank mix of assets and liabilities will enhance its net interest income ( NII ) (the difference between the interest earned on loans and investments and the interest paid on deposits and borrowings) and will increase other fee income, although there can be no assurance in this regard. Such loans, however, generally involve a higher degree of risk than financing residential real estate. Sterling s revenues are derived primarily from interest earned on loans and mortgage-backed securities ( MBS ), fees and service charges, and mortgage banking operations. The operations of Sterling, and banking institutions generally, are influenced significantly by general economic conditions and by policies of its primary regulatory authorities, the Board of Governors of the Federal Reserve System ( FRB ), the FDIC and the State of Washington Department of Financial Institutions ( Washington Supervisor ).

**Company Growth**

During 2005, Sterling Savings Bank expanded its service network with ten new financial service centers, including retail branches, business banking teams, private banking teams and a corporate banking team.

In January 2004, Sterling completed its acquisition of Klamath First Bancorp, Inc. ( KFBI ), in which KFBI was merged with and into Sterling, with Sterling being the surviving corporation, and KFBI s wholly owned subsidiary, Klamath First Federal Savings and Loan Association, was merged with and into Sterling s wholly owned subsidiary, Sterling Savings Bank, with Sterling Savings Bank being the surviving institution.

Subsequent to the end of Sterling s 2005 fiscal year, on February 13, 2006, Sterling issued a joint press release with Lynnwood Financial Group, Inc., the parent company of Golf Savings Bank, announcing that they had signed a definitive agreement for the merger of Lynnwood Financial Group, Inc., with and into Sterling. Lynnwood s subsidiaries, Golf Savings Bank and Golf Escrow Corporation, are expected to continue operations as wholly-owned subsidiaries of Sterling. The transaction, which is valued at approximately \$65.3 million, is expected to close in the third quarter of 2006, pending receipt of regulatory and Lynnwood shareholder approvals and satisfaction of other customary closing conditions, and is expected to be accretive to Sterling s earnings per share in 2006.

## **Table of Contents**

Sterling intends to continue to pursue an aggressive growth strategy to become the leading community bank in the Pacific Northwest. This strategy may include acquiring other financial businesses or branches thereof, or other substantial assets or deposit liabilities. Sterling may not be successful in identifying further acquisition candidates, integrating acquisitions or preventing such acquisitions from having an adverse effect on Sterling. There is significant competition for acquisitions in Sterling's market area, and Sterling may not be able to acquire other businesses on attractive terms. Furthermore, the success of Sterling's growth strategy will depend on increasing and maintaining sufficient levels of regulatory capital, obtaining necessary regulatory approvals, generating appropriate growth and the existence of favorable economic and market conditions. There can be no assurance that Sterling will be successful in implementing its growth strategy.

### **Profitability Drivers**

We expect to increase our profitability in the future by:

- continuing to increase the volume of our loans and change the mix of our loan portfolio to higher-yielding business banking, corporate banking and consumer loans.

- growing our core deposits, particularly non-interest bearing consumer and commercial transaction deposits.

- expanding products and services for corporate and business customers, including depository and treasury management services such as lockbox, on-line net banking, merchant services, analyzed and sweep accounts, remote deposit and international services.

- diversifying and growing our fee income through existing and new fee income sources, including deposit fees, transaction fees, fees from mortgage banking and other fees.

- maintaining strong asset quality through robust underwriting and credit approval functions.

- managing interest rate risk to protect net interest margin in a changing interest rate environment.

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

### **Lending Activities**

**Focus on Community Lending.** In recent years, Sterling began repositioning its loan portfolio and operations to be more like that of a community bank. In July 2005, Sterling completed the transition by converting to a commercial bank. Commercial real estate, business banking, consumer and construction loans generally produce higher yields than residential permanent mortgage loans. Such loans, however, generally involve a higher degree of risk than financing residential real estate.

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

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

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





**Table of Contents**

Sterling has established minimum underwriting standards, which delineate criteria for sources of repayment, financial strength and credit enhancements such as guarantees. Typically, the primary source of repayment is recurring cash flow of the borrower or cash flow from the business or project being financed. Depending on the type of loan, underwriting standards include minimum financial requirements, maximum loan-to-collateral value ratios, minimum cash flow coverage of debt service, debt-to-income ratios and minimum liquidity requirements. Exceptions to the minimum underwriting standards may be made depending upon the type of loan and financial strength of the borrower. Exceptions are reported to the appropriate level of authority up to and including the board of directors. Common forms of collateral pledged to secure business banking loans include real estate, accounts receivable, inventory, equipment, agricultural crops or livestock and marketable securities. Most loans have maximum terms of one to ten years and loan-to-value ratios in the range of 65% to 80%, based on an analysis of the collateral pledged. Business, corporate and private banking loans generally involve a higher degree of risk than financing real estate, primarily because collateral is more difficult to appraise, the collateral may be difficult to obtain or liquidate following an uncured default and it is difficult to accurately predict the borrower's ability to generate future cash flows. These loans, however, typically offer relatively higher yields and variable interest rates. The availability of such loans enables potential depositors to establish full-service banking relationships with Sterling.

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

***One- to Four-Family Residential Lending.*** Sterling originates fixed- and adjustable-rate residential mortgages ( ARMs ), which have interest rates that adjust annually or every three, five or seven years and are indexed to a variety of market indices, as well as interest only residential mortgages.

Sterling continues to originate conventional and government-insured residential loans for sale into the secondary mortgage market. Within the secondary mortgage market for conventional loans, Sterling sells its residential loans both on a servicing-released and servicing-retained basis. Sterling also sells loans to the Federal Home Loan Mortgage Corporation ( FHLMC ), the Federal Home Loan Bank ( FHLB Seattle ) and the Federal National Mortgage Association ( FNMA ). Sterling endeavors to underwrite residential loans in compliance with these agencies' underwriting standards. Loans sold into the secondary market are all sold without recourse to Sterling, except that Sterling may be obligated to repurchase any loans that are not underwritten in accordance with these agencies' or applicable investor underwriting guidelines.

Conventional residential mortgage loans are originated for up to 103% of the appraised value or selling price of the mortgaged property, whichever is less. Borrowers must purchase private mortgage insurance from approved third parties so that Sterling's risk is limited to approximately 80% of the appraised value on all loans with loan-to-value ratios in excess of 80%. Sterling's residential lending programs are designed to comply with all applicable regulatory requirements. For a discussion of Sterling's management of interest rate risk ( IRR ) on conventional loans, see *Secondary Market Activities*.



**Table of Contents**

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

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

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

|                                 | Years Ended December 31, |      |            |      |            |      |
|---------------------------------|--------------------------|------|------------|------|------------|------|
|                                 | 2005                     |      | 2004       |      | 2003       |      |
|                                 | Amount                   | %    | Amount     | %    | Amount     | %    |
|                                 | (Dollars in thousands)   |      |            |      |            |      |
| Mortgage permanent:             |                          |      |            |      |            |      |
| One- to four-family residential | \$ 461,414               | 11.9 | \$ 400,391 | 13.7 | \$ 504,169 | 22.2 |
| Multifamily residential         | 57,571                   | 1.5  | 43,395     | 1.5  | 71,962     | 3.2  |
| Commercial real estate          | 218,396                  | 5.6  | 241,754    | 8.3  | 114,487    | 5.0  |
|                                 | 737,381                  | 19.0 | 685,540    | 23.5 | 690,618    | 30.4 |
| Mortgage construction:          |                          |      |            |      |            |      |
| One- to four-family residential | 1,106,632                | 28.5 | 719,146    | 24.6 | 531,875    | 23.4 |
| Multifamily residential         | 175,018                  | 4.5  | 102,970    | 3.5  | 79,463     | 3.5  |
| Commercial property             | 519,893                  | 13.4 | 203,401    | 7.0  | 96,213     | 4.2  |
|                                 | 1,801,543                | 46.4 | 1,025,517  | 35.1 | 707,551    | 31.1 |
| Total mortgage loans            | 2,538,924                | 65.4 | 1,711,057  | 58.6 | 1,398,169  | 61.5 |
| Commercial and consumer:        |                          |      |            |      |            |      |
| Corporate banking               | 351,228                  | 9.1  | 352,767    | 12.1 | 204,733    | 9.0  |
| Business banking                | 547,540                  | 14.1 | 465,827    | 16.0 | 386,521    | 17.0 |
| Consumer direct                 | 353,840                  | 9.1  | 332,076    | 11.4 | 211,505    | 9.3  |

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|                                     |              |       |              |       |              |       |
|-------------------------------------|--------------|-------|--------------|-------|--------------|-------|
| Consumer indirect                   | 90,096       | 2.3   | 56,403       | 1.9   | 73,046       | 3.2   |
| Total commercial and consumer loans | 1,342,704    | 34.6  | 1,207,073    | 41.4  | 875,805      | 38.5  |
| Total loans originated              | \$ 3,881,628 | 100.0 | \$ 2,918,130 | 100.0 | \$ 2,273,974 | 100.0 |

4

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**Table of Contents**

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

|   | 2005                   |      | 2004       |      | December 31,<br>2003 |      | 2002       |      | 2001       |      |
|---|------------------------|------|------------|------|----------------------|------|------------|------|------------|------|
|   | Amount                 | %    | Amount     | %    | Amount               | %    | Amount     | %    | Amount     | %    |
|   | (Dollars in thousands) |      |            |      |                      |      |            |      |            |      |
| Mortgage permanent:                     |                        |      |            |      |                      |      |            |      |            |      |
| One- to four-family residential         | \$ 488,633             | 9.9  | \$ 794,632 | 18.4 | \$ 407,999           | 13.8 | \$ 358,359 | 14.8 | \$ 315,242 | 14.8 |
| Multifamily residential                 | 332,211                | 6.7  | 184,754    | 4.3  | 167,220              | 5.7  | 161,547    | 6.7  | 155,250    | 7.3  |
| Commercial real estate                  | 792,219                | 16.0 | 699,879    | 16.3 | 463,191              | 15.7 | 458,712    | 18.9 | 438,594    | 20.5 |
| Land and other                          | 0                      | 0.0  | 0          | 0.0  | 0                    | 0.0  | 0          | 0.0  | 925        | 0.0  |
|   | 1,613,063              | 32.6 | 1,679,265  | 39.0 | 1,038,410            | 35.2 | 978,618    | 40.4 | 910,011    | 42.6 |
| Mortgage construction:                  |                        |      |            |      |                      |      |            |      |            |      |
| One- to four-family residential         | 591,362                | 11.9 | 356,644    | 8.3  | 271,480              | 9.2  | 280,514    | 11.6 | 214,849    | 10.1 |
| Multifamily residential                 | 143,272                | 2.9  | 102,166    | 2.4  | 127,424              | 4.3  | 96,297     | 4.0  | 88,977     | 4.2  |
| Commercial real estate                  | 286,868                | 5.8  | 194,085    | 4.5  | 154,061              | 5.2  | 104,108    | 4.3  | 92,089     | 4.3  |
|   | 1,021,502              | 20.6 | 652,895    | 15.2 | 552,965              | 18.7 | 480,919    | 19.9 | 395,915    | 18.6 |
| Total mortgage loans                    | 2,634,565              | 53.2 | 2,332,160  | 54.2 | 1,591,375            | 53.9 | 1,459,537  | 60.3 | 1,305,926  | 61.2 |
| Commercial and consumer:                |                        |      |            |      |                      |      |            |      |            |      |
| Business, private and corporate banking | 1,531,079              | 30.9 | 1,311,197  | 30.4 | 948,304              | 32.2 | 655,727    | 27.0 | 520,866    | 24.3 |
| Consumer direct                         | 618,528                | 12.5 | 543,895    | 12.6 | 309,931              | 10.5 | 246,578    | 10.2 | 244,097    | 11.4 |
|   | 166,143                | 3.4  | 120,894    | 2.8  | 99,697               | 3.4  | 62,896     | 2.5  | 65,169     | 3.1  |

|  |              |       |              |       |              |       |              |       |              |       |
|--|--------------|-------|--------------|-------|--------------|-------|--------------|-------|--------------|-------|
| Consumer indirect                            |              |       |              |       |              |       |              |       |              |       |
| Total commercial and consumer loans          | 2,315,750    | 46.8  | 1,975,986    | 45.8  | 1,357,932    | 46.1  | 965,201      | 39.7  | 830,132      | 38.8  |
| Total loans receivable                       | 4,950,315    | 100.0 | 4,308,146    | 100.0 | 2,949,307    | 100.0 | 2,424,738    | 100.0 | 2,136,058    | 100.0 |
| Deferred loan origination fees, net of costs | (8,916)      |       | (6,907)      |       | (7,276)      |       | (6,450)      |       | (5,980)      |       |
| Gross loans receivable                       | 4,941,399    |       | 4,301,239    |       | 2,942,031    |       | 2,418,288    |       | 2,130,078    |       |
| Allowance for loan losses                    | (55,483)     |       | (49,362)     |       | (35,605)     |       | (27,866)     |       | (20,599)     |       |
| Loans receivable, net                        | \$ 4,885,916 |       | \$ 4,251,877 |       | \$ 2,906,426 |       | \$ 2,390,422 |       | \$ 2,109,479 |       |

**Table of Contents**

**Contractual Principal Payments.** The following table sets forth the scheduled contractual principal repayments for Sterling's loan portfolio at December 31, 2005. Demand loans, loans having no stated repayment schedule and no stated maturity, and overdrafts are reported as due in one year or less. Loan balances do not include undisbursed loan proceeds, deferred loan origination costs and fees, or allowances for loan losses.

|   | <b>Balance<br/>Outstanding at<br/>December 31,<br/>2005</b> | <b>Principal Payments<br/>Contractually Due in Fiscal Years</b> |                  |                   |
|---|---|---|------------------|-------------------|
|   |   | <b>2006</b>   | <b>2007-2010</b> | <b>Thereafter</b> |
|   |   | <b>(Dollars in thousands)</b>                                   |                  |                   |
| Mortgage permanent:                     |   |   |                  |                   |
| Fixed rate                              | \$ 597,311  | \$ 31,153   | \$ 118,699       | \$ 447,459        |
| Variable rate                           | 1,015,752   | 47,063  | 359,945          | 608,744           |
| Mortgage construction                   | 1,021,502   | 550,858   | 441,086          | 29,558            |
| Consumer direct                         | 618,528   | 235,581   | 110,002          | 272,945           |
| Consumer indirect                       | 166,143   | 36,381  | 120,119          | 9,643             |
| Business, private and corporate banking | 1,531,079   | 822,223   | 354,573          | 354,283           |
|   | \$ 4,950,315  | \$ 1,723,259  | \$ 1,504,424     | \$ 1,722,632      |

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

For residential mortgage loans serviced for other investors, Sterling receives a fee, generally ranging from 5 to 25 basis points of the unpaid principal balance. At December 31, 2005 and 2004, Sterling serviced for itself and for other investors, residential mortgage loans totaling \$972.5 million and \$1.17 billion, respectively. Of such mortgage loans, Sterling serviced \$606.7 million and \$373.6 million, respectively, at these dates for FHLMC, FHLB and FNMA. Sterling's ability to continue as a seller/servicer for these agencies is dependent upon meeting their qualifications. Sterling currently meets all applicable requirements.

Sterling receives a fee for servicing commercial and multifamily real estate loans for other investors. This fee generally ranges from 10 to 25 basis points of the unpaid principal balance. At December 31, 2005 and 2004, Sterling serviced for itself and other investors, commercial and multifamily real estate loans totaling \$1.74 billion and \$1.48 billion, respectively.

Sterling also receives a fee of 50 basis points of the unpaid principal balance of each loan for servicing automobile loans for other investors. At December 31, 2005 and 2004, Sterling serviced \$3.1 million and \$7.8 million of such loans, respectively.

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

Sterling, from time to time, sells participations in certain commercial real estate loans to investors on a servicing-retained basis. During the years ended December 31, 2005 and 2004, Sterling sold approximately \$125.5 million and \$16.3 million in loans under participation agreements, resulting in net gains of \$449,000 and \$44,000, respectively.

Sterling generally receives a fee of approximately 100 to 200 basis points of the principal balance of mortgage loans for releasing the servicing. In 2005, 94% of Sterling's sales of Federal Housing Administration (FHA) and Department of Veterans Affairs (VA) insured loans were sold into the secondary market on a loan-by-loan, servicing-released basis, compared with 64% in 2004.



**Table of Contents**

In 2005, 6% of Sterling's sales of conventional, FHA and VA insured loans were sold into the secondary market on a servicing-retained basis, compared with 36% in 2004. Sterling records a valuation of approximately 100 to 115 basis points of the principal balance of such loans for retaining the servicing. At December 31, 2005 and 2004, Sterling had recorded as net assets \$5.4 million and \$4.1 million in servicing rights, respectively. See Note 3 of Notes to Consolidated Financial Statements.

***Loan Commitments.*** Sterling makes written commitments to individual borrowers and mortgage brokers for the purposes of originating and purchasing loans. These loan commitments establish the terms and conditions under which Sterling will fund the loans. Sterling had outstanding commitments to originate or purchase loans, the undisbursed portion of which aggregated \$925.8 million and \$485.2 million at December 31, 2005 and 2004, respectively. Sterling also had secured and unsecured commercial and personal lines of credit, the undisbursed portion of which was approximately \$826.2 million and \$623.1 million at December 31, 2005 and 2004, respectively. See Note 17 of Notes to Consolidated Financial Statements.

***Derivatives and Hedging.*** Sterling, through its subsidiary Action Mortgage, enters into interest rate lock commitments to prospective residential mortgage borrowers. Action Mortgage hedges IRR by entering into nonbinding (best-efforts) forward sales agreements with third parties. In addition, to improve and protect the profit margin on loans sold into the secondary market, Action Mortgage hedges IRR by entering into binding (mandatory) forward sales agreements on MBS with third parties.

The risks inherent in such mandatory forward sales agreements include the risk that, if for any reason Action Mortgage does not close and sell the loans in question, it is nonetheless obligated to deliver MBS to the counterparty on the agreed terms. Action Mortgage could incur significant costs in acquiring replacement loans or MBS and such costs could have a material adverse impact on mortgage banking operations in future periods, especially in rising interest rate environments. During the years ended December 31, 2005 and 2004, Sterling recorded \$168,000 and \$231,000 in revenue from forward sales agreements and similar transactions, respectively. This revenue is a component of income from mortgage banking operations in the income statement.

Rate lock commitments and forward sales agreements are considered to be derivatives. Sterling has recorded the estimated fair values of the rate lock commitments and forward sales agreements on its balance sheet in either other assets or other liabilities. Changes in the fair values of these derivative instruments are recorded in income from mortgage banking operations in the income statement as the changes occur. The estimated fair value of rate lock commitments and forward sales agreements as compared to the contracted amounts resulted in an asset of \$147,000 and a liability of \$25,000, respectively, at December 31, 2005. Rate lock commitments and forward sales agreements were assets of \$76,000 and \$12,000, respectively, at December 31, 2004.

***Classified Assets, Real Estate Owned and Delinquent Loans.*** To measure the quality of assets, including loans and real estate owned (REO), Sterling has established guidelines for classifying assets and determining provisions for anticipated loan and REO losses. Under these guidelines, an allowance for anticipated loan and REO losses is established when certain conditions exist. This system for classifying and reserving for loans and REO is administered by Sterling's Special Assets and Asset Recovery Departments, which are responsible for minimizing loan deficiencies and losses therefrom. An oversight committee, comprised of senior management, monitors the activities of the Special Assets and Asset Recovery Departments and reports results to Sterling's Board of Directors.

Under this system, Sterling classifies loans and other assets it considers of questionable quality. Sterling's system employs the classification categories of substandard, doubtful and loss. Substandard assets have deficiencies, which give rise to the distinct possibility that Sterling will sustain some loss if the deficiencies are not corrected. Doubtful assets have the weaknesses of substandard assets, and on the basis of currently existing facts, there is a high probability of loss. An asset classified as loss is considered uncollectible and of such little value that it should not be included as an asset of Sterling. Total classified assets decreased to \$59.6 million at December 31, 2005, from \$68.3 million at December 31, 2004. As a percentage of total assets, classified assets decreased from the prior year. The percentage of classified assets to total assets was 0.79% and 0.98% at December 31, 2005 and 2004, respectively. See *Major Classified Loans*.

Assets classified as substandard or doubtful require the establishment of valuation allowances in amounts considered by management to be adequate under accounting principles generally accepted in the United States of America

( GAAP ). Assets classified as loss require either a specific valuation allowance of 100% of the amount classified or a write-off of such amount. At December 31, 2005, Sterling s assets classified as loss totaled \$2.2 million compared to \$3.6 million at December 31, 2004. Judgments regarding the adequacy of a valuation allowance are based on ongoing evaluations of the nature, volume and quality of the loan portfolio, REO, specific problem assets and current economic conditions that may affect the recoverability of recorded amounts.

**Table of Contents**

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

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

|                                       | <b>Years Ended December 31,</b> |             |             |
|---------------------------------------|---------------------------------|-------------|-------------|
|                                       | <b>2005</b>                     | <b>2004</b> | <b>2003</b> |
|                                       | <b>(Dollars in thousands)</b>   |             |             |
| Balance at beginning of period        | \$ 1,865                        | \$ 4,226    | \$ 3,953    |
| Loan foreclosures and other additions | 2,271                           | 4,445       | 3,900       |
| Improvements and other changes        | 331                             | (132)       | 282         |
| Sales                                 | (3,665)                         | (6,669)     | (3,729)     |
| Provisions for losses                 | (23)                            | (5)         | (180)       |
| Balance at end of period              | \$ 779                          | \$ 1,865    | \$ 4,226    |

**Major Classified Loans.** Sterling's classified loans, with a net carrying value at December 31, 2005 of more than \$5.0 million each, which together constitute 51% of classified assets, included the following:

Sterling holds six commercial loans secured by real estate, inventory and accounts receivable. The aggregate carrying value of these loans at December 31, 2005, was \$9.1 million. These loans have been classified due to declining sales and high operating expenses. These loans remain current.

Sterling holds an income property loan secured by a specialized care facility. The aggregate carrying value of this loan at December 31, 2005 was \$8.1 million. This loan remains current.

Sterling holds an owner occupied commercial real estate loan and three flooring lines for an auto dealership. The aggregate carrying value of these loans at December 31, 2005 was \$7.8 million. These loans are secured by commercial and personal real estate. These loans remain current.

Sterling holds an income property loan secured by a specialized care facility. The aggregate carrying value of this loan at December 31, 2005 was \$5.1 million. The loan has been classified due to the facility's low occupancy rates. This loan remains current.

**Major Real Estate Owned.** At December 31, 2005, the aggregate value of REO properties was relatively low at \$779,000, as asset quality and the economy improved during the year. Additionally, the value of REO was reduced when a large REO property was sold.

**Delinquent Loan Procedures.** Delinquent and problem loans are part of any lending business. If a borrower fails to make a required payment when due, Sterling institutes internal collection procedures. For residential mortgage and consumer loans, Sterling's collection procedures generally require that an initial request for payment be mailed to the borrower when the loan is 15 days past due. At 25 days past due, the borrower is contacted by telephone and payment is requested orally. At 30 days past due, Sterling records the loan as a delinquency. In the case of delinquent residential mortgage loans, a notice of intent to foreclose is mailed at 45 days past due. If the loan is still delinquent 30 days following the mailing of the notice of intent to foreclose, Sterling generally initiates foreclosure proceedings. For consumer loans, a demand letter is sent when the account becomes delinquent for two payments. Additional collection work or repossession may follow. In certain instances, Sterling may modify the loan or grant a limited moratorium on loan payments to enable the borrower to reorganize his or her financial affairs. Collection procedures similar to those used for consumer and residential mortgage loans are followed for commercial, construction and income property loans, with the exception that these accounts are generally handled as a joint effort between the originating loan officer and the Special Assets Department during initial stages of delinquency. On or before 60 days of delinquency, the collection effort is typically shifted from the originating loan officer to the Special Assets

Department.

**Table of Contents**

The following table summarizes the principal balances of nonperforming assets at the dates indicated:

|  | <b>December 31,</b>           |             |             |             |             |
|--|-------------------------------|-------------|-------------|-------------|-------------|
|  | <b>2005</b>                   | <b>2004</b> | <b>2003</b> | <b>2002</b> | <b>2001</b> |
|  | <b>(Dollars in thousands)</b> |             |             |             |             |
| Nonaccrual loans   | \$ 6,542                      | \$ 10,738   | \$ 16,208   | \$ 16,278   | \$ 21,102   |
| Restructured loans   | 1,081                         | 1,305       | 1,164       | 594         | 886         |
| Total nonperforming loans  | 7,623                         | 12,043      | 17,372      | 16,872      | 21,988      |
| Real estate owned <sup>(1)</sup>   | 779                           | 1,865       | 4,226       | 3,953       | 2,982       |
| Total nonperforming assets   | \$ 8,402                      | \$ 13,908   | \$ 21,598   | \$ 20,825   | \$ 24,970   |
| Ratio of total nonperforming assets to total assets  | 0.11%                         | 0.20%       | 0.50%       | 0.59%       | 0.82%       |
| Ratio of total nonperforming loans to gross loans  | 0.15%                         | 0.28%       | 0.59%       | 0.70%       | 1.03%       |
| Ratio of allowance for estimated losses on loans to total nonperforming loans <sup>(2)</sup> | 975.9%                        | 538.3%      | 216.6%      | 174.3%      | 91.9%       |

(1) Amount is net of the allowance for REO losses.

(2) Excludes loans classified as loss. Loans classified as loss that are excluded from allowance for loan losses were \$2,159,000, \$3,528,000, \$2,897,000, \$2,067,000 and \$1,843,000 at December 31, 2005, 2004, 2003, 2002 and 2001, respectively. There were no loans classified as loss that are excluded from total nonperforming

loans in any of  
the periods.

Sterling regularly reviews the collectibility of accrued interest and generally ceases to accrue interest on a loan when either principal or interest is past due by 90 days or more. Any accrued and uncollected interest is reversed from income at that time. Loans may be placed in nonaccrual status earlier if, in management's judgment, the loan may be uncollectible. Interest on such a loan is then recognized as income only if collected or if the loan is restored to performing status. Interest income of \$258,000, \$659,000 and \$1,025,000 was recorded on these loans during the years ended December 31, 2005, 2004 and 2003, respectively. Additional interest income of \$693,000, \$1,348,000 and \$1,487,000 would have been recorded during the years ended December 31, 2005, 2004 and 2003, respectively, if nonaccrual and restructured loans had been current in accordance with their original contractual terms.

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

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

Additions to the allowance, in the form of provisions, are reflected in current operating results, while charge-offs to the allowance are made when a loss is determined to have occurred. Because the allowance for loan losses is based on estimates, ultimate losses may materially differ from the estimates. See Note 5 of Notes to Consolidated Financial Statements.

**Table of Contents**

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

|   | <b>Years Ended December 31,</b> |             |             |             |             |
|---|---------------------------------|-------------|-------------|-------------|-------------|
|   | <b>2005</b>                     | <b>2004</b> | <b>2003</b> | <b>2002</b> | <b>2001</b> |
|   | <b>(Dollars in thousands)</b>   |             |             |             |             |
| Balance at beginning of period  | \$ 49,362                       | \$ 35,605   | \$ 27,866   | \$ 20,599   | \$ 16,740   |
| Charge-offs:  |                                 |             |             |             |             |
| Mortgage permanent  | (37)                            | (59)        | (165)       | (48)        | (270)       |
| Mortgage construction   | (19)                            | (645)       | (106)       | (868)       | (756)       |
| Consumer direct   | (1,107)                         | (1,373)     | (1,146)     | (954)       | (1,011)     |
| Consumer indirect   | (449)                           | (370)       | (445)       | (407)       | (544)       |
| Business, private and corporate banking                                 | (8,039)                         | (3,036)     | (2,391)     | (2,776)     | (2,016)     |
| Total charge-offs   | (9,651)                         | (5,483)     | (4,253)     | (5,053)     | (4,597)     |
| Recoveries:   |                                 |             |             |             |             |
| Mortgage permanent  | 6                               | 25          | 42          | 19          | 9           |
| Mortgage construction   | 0                               | 2           | 3           | 2           | 31          |
| Consumer direct   | 237                             | 214         | 160         | 208         | 203         |
| Consumer indirect   | 201                             | 111         | 149         | 170         | 184         |
| Business, private and corporate banking                                 | 128                             | 16          | 268         | 54          | 29          |
| Total recoveries  | 572                             | 368         | 622         | 453         | 456         |
| Net charge-offs   | (9,079)                         | (5,115)     | (3,631)     | (4,600)     | (4,141)     |
| Provisions for loan losses  | 15,200                          | 12,150      | 10,500      | 11,867      | 8,000       |
| Allowance for losses on assets acquired                                 | 0                               | 6,722       | 870         | 0           | 0           |
| Balance at end of period  | \$ 55,483                       | \$ 49,362   | \$ 35,605   | \$ 27,866   | \$ 20,599   |
| Allowances allocated to loans classified as loss                        | \$ 2,159                        | \$ 3,528    | \$ 2,897    | \$ 2,067    | \$ 1,843    |
| Ratio of net charge-offs to average loans outstanding during the period | 0.20%                           | 0.13%       | 0.13%       | 0.21%       | 0.21%       |

**Table of Contents**

Allowances are provided for individual loans when management considers ultimate collection to be questionable. Such allowances are based, among other factors, upon the estimated net realizable value of the collateral of the loan or guarantees, if applicable. The following table sets forth the allowances for estimated losses on loans by category and summarizes the percentage of total loans in each category to total loans:

|   | December 31,                         |             |                                      |             |                                      |             |                                      |             |                                      |             |
|---|--------------------------------------|-------------|--------------------------------------|-------------|--------------------------------------|-------------|--------------------------------------|-------------|--------------------------------------|-------------|
|   | 2005                                 |             | 2004                                 |             | 2003                                 |             | 2002                                 |             | 2001                                 |             |
|   | Loans in Category as a Percentage of |             | Loans in Category as a Percentage of |             | Loans in Category as a Percentage of |             | Loans in Category as a Percentage of |             | Loans in Category as a Percentage of |             |
|   | Allowance Amount                     | Total Loans | Allowance Amount                     | Total Loans | Allowance Amount                     | Total Loans | Allowance Amount                     | Total Loans | Allowance Amount                     | Total Loans |
|   | (Dollars in thousands)               |             |                                      |             |                                      |             |                                      |             |                                      |             |
| Mortgage permanent                      | \$ 14,576                            | 32.6        | \$ 10,632                            | 39.0        | \$ 4,902                             | 35.2        | \$ 2,881                             | 40.4        | \$ 2,285                             | 42.6        |
| Mortgage construction                   | 8,016                                | 20.6        | 6,264                                | 15.2        | 6,336                                | 18.7        | 6,199                                | 19.9        | 3,601                                | 18.6        |
| Consumer direct                         | 6,795                                | 12.5        | 7,247                                | 12.6        | 3,843                                | 10.5        | 2,986                                | 10.2        | 2,812                                | 11.4        |
| Consumer indirect                       | 1,205                                | 3.4         | 1,156                                | 2.8         | 1,676                                | 3.4         | 1,349                                | 2.5         | 1,202                                | 3.1         |
| Business, private and corporate banking | 23,626                               | 30.9        | 23,710                               | 30.4        | 17,979                               | 32.2        | 14,014                               | 27.0        | 10,211                               | 24.3        |
| Unallocated                             | 1,265                                | N/A         | 353                                  | N/A         | 869                                  | N/A         | 437                                  | N/A         | 488                                  | N/A         |
|   | \$ 55,483                            | 100.0       | \$ 49,362                            | 100.0       | \$ 35,605                            | 100.0       | \$ 27,866                            | 100.0       | \$ 20,599                            | 100.0       |



**Table of Contents****Investments and Mortgage-Backed Securities**

Investments and MBS that management has the positive intent and ability to hold to maturity are classified as held to maturity and carried at amortized cost. At December 31, 2005 and 2004, investments and MBS classified as held to maturity were \$51.9 million and \$47.4 million, respectively. See MD&A Critical Accounting Policies *Investments and MBS*.

At December 31, 2005 and 2004, investments and MBS classified as available for sale were \$2.08 billion and \$2.16 billion, respectively. The carrying value of these investments and MBS at December 31, 2005 and 2004 includes net unrealized losses of \$54.1 million and \$14.8 million, respectively. Fluctuations in prevailing interest rates continue to cause volatility in this component of accumulated comprehensive income and may continue to do so in future periods. See MD&A Critical Accounting Policies *Investments and MBS*.

Sterling invests primarily in MBS issued by FHLMC and FNMA and other agency obligations. Such investments provide Sterling with a relatively liquid source of interest income and collateral, which can be used to secure borrowings. Sterling invests primarily in investment-grade investments and MBS. See MD&A Results of Operations *Non-Interest Income and Non-Interest Expense* and Note 1 of Notes to Consolidated Financial Statements.

The following table provides the carrying values, contractual maturities and weighted average yields of Sterling's investment and MBS portfolio at December 31, 2005. Actual maturities may differ from the contractual maturities, because issuers may have the right to call or prepay obligations with or without prepayment penalties.

|  | <b>Less<br/>than<br/>One<br/>Year</b> | <b>One to<br/>Five<br/>Years</b> | <b>Maturity<br/>Over Five<br/>to<br/>Ten Years</b> | <b>Over Ten<br/>Years</b> | <b>Total</b>        |
|--|---------------------------------------|----------------------------------|--|---------------------------|---------------------|
|  | <b>(Dollars in thousands)</b>         |                                  |  |                           |                     |
| Mortgage-backed securities             |                                       |                                  |  |                           |                     |
| Balance                                | \$ 0                                  | \$ 15,628                        | \$ 88,828  | \$ 1,856,126              | \$ 1,960,582        |
| Weighted average yield                 | 0.00%                                 | 3.57%                            | 3.87%  | 4.73%                     | 4.68%               |
| U.S. government and agency obligations |                                       |                                  |  |                           |                     |
| Balance                                | \$ 7,956                              | \$ 13,837                        | \$ 0   | \$ 0                      | \$ 21,793           |
| Weighted average yield                 | 3.75%                                 | 4.05%                            | 0.00%  | 0.00%                     | 3.94%               |
| FHLB Seattle stock, at cost            |                                       |                                  |  |                           |                     |
| Balance                                | \$ 0                                  | \$ 0                             | \$ 0   | \$ 76,626                 | \$ 76,626           |
| Weighted average yield <sup>(1)</sup>  | 0.00%                                 | 0.00%                            | 0.00%  | 0.00%                     | 0.00%               |
| Municipal bonds                        |                                       |                                  |  |                           |                     |
| Balance                                | \$ 350                                | \$ 2,816                         | \$ 7,234   | \$ 40,507                 | \$ 50,907           |
| Weighted average yield <sup>(2)</sup>  | 4.60%                                 | 3.73%                            | 3.81%  | 4.64%                     | 4.47%               |
| Other <sup>(3)</sup>                   |                                       |                                  |  |                           |                     |
| Balance                                | \$ 857                                | \$ 160                           | \$ 1,500   | \$ 16,114                 | \$ 18,631           |
| Weighted average yield                 | 3.47%                                 | 3.49%                            | 0.00%  | 0.00%                     | 0.04%               |
| <b>Total carrying value</b>            | <b>\$ 9,163</b>                       | <b>\$ 32,441</b>                 | <b>\$ 97,562</b>                                   | <b>\$ 1,989,373</b>       | <b>\$ 2,128,539</b> |
| <b>Weighted average yield</b>          | <b>3.76%</b>                          | <b>3.79%</b>                     | <b>3.81%</b>                                       | <b>4.51%</b>              | <b>4.46%</b>        |

<sup>(1)</sup> FHLB Seattle is not currently paying

dividends.

- (2) The weighted average yields on municipal bonds reflect the actual yields on the bonds and are not presented on a tax-equivalent basis.
- (3) Other investments relate primarily to limited partnership interests in low-income housing projects.

**Table of Contents**

The following table sets forth the carrying values and classifications for financial statement reporting purposes of Sterling's investment and MBS portfolio at the dates indicated:

|  | 2005                   | December 31,<br>2004 | 2003                |
|--|------------------------|----------------------|---------------------|
|  | (Dollars in thousands) |                      |                     |
| Mortgage-backed securities             | \$ 1,960,582           | \$ 2,036,920         | \$ 983,736          |
| U.S. government and agency obligations | 21,793                 | 28,070               | 13,333              |
| FHLB Seattle stock                     | 76,626                 | 74,846               | 51,261              |
| Municipal bonds                        | 50,907                 | 47,449               | 6,285               |
| Other                                  | 18,631                 | 17,300               | 18,569              |
| <b>Total</b>                           | <b>\$ 2,128,539</b>    | <b>\$ 2,204,585</b>  | <b>\$ 1,073,184</b> |
| Available for sale                     | 2,076,615              | 2,157,136            | 1,070,955           |
| Held to maturity                       | 51,924                 | 47,449               | 2,229               |
| <b>Total</b>                           | <b>\$ 2,128,539</b>    | <b>\$ 2,204,585</b>  | <b>\$ 1,073,184</b> |
| Weighted average yield                 | 4.46%                  | 4.50%                | 4.62%               |

**Sources of Funds**

**General.** Sterling's primary sources of funds for use in lending and for other general business purposes are deposits, loan repayments, FHLB Seattle advances, secured lines of credit and other borrowings, proceeds from sales of investments and MBS, and proceeds from sales of loans. Scheduled loan repayments are a relatively stable source of funds, while other sources of funds are influenced significantly by prevailing interest rates, interest rates available on other borrowings and other economic conditions. Borrowings may be used on a short-term basis to compensate for reductions in other sources of funds (such as deposit inflows at less than projected levels). Borrowings may also be used on a longer-term basis to support expanded lending activities and to match repricing intervals of assets. See Lending Activities and Investments and Mortgage-Backed Securities.

**Deposit Activities.** As a regional community bank, Sterling offers a variety of accounts for depositors designed to attract both short-term and long-term deposits from the general public. These accounts include money market deposit accounts ( MMDA ), checking accounts, savings accounts and certificates of deposit ( CDs ) accounts. Sterling offers both interest- and non-interest-bearing checking accounts. The interest-bearing checking accounts can be subject to monthly service charges, unless a minimum balance is maintained. MMDA, CDs and savings accounts earn interest at rates established by management and are based on a competitive market analysis. The method of compounding varies from simple interest credited at maturity to daily compounding, depending on the type of account.

With the exception of certain promotional CDs and variable-rate 18-month Individual Retirement Account certificates, all CDs carry a fixed rate of interest for a defined term from the opening date of the account. Substantial penalties are imposed if principal is withdrawn from most CDs prior to maturity.

Sterling supplements its retail deposit gathering by soliciting funds from public entities and acquiring brokered deposits. Public funds were 8.9% and 8.5% of deposits at December 31, 2005 and 2004, respectively. Public funds are generally obtained by competitive bidding among qualifying financial institutions. Sterling had \$628.3 million and \$375.3 million of brokered deposits at December 31, 2005 and 2004, respectively.

**Table of Contents**

The primary deposit vehicles being utilized by Sterling's customers are CDs with terms of one year or less, regular savings accounts, MMDA, interest-bearing transaction accounts and non-interest-bearing transaction accounts. The following table presents the average balance outstanding and weighted average interest rate paid for each major category of deposits for the periods indicated:

|                          | Years Ended December 31, |                                |                 |                                |                 |                                |
|--------------------------|--------------------------|--------------------------------|-----------------|--------------------------------|-----------------|--------------------------------|
|                          | 2005                     |                                | 2004            |                                | 2003            |                                |
|                          | Average Balance          | Weighted Average Interest Rate | Average Balance | Weighted Average Interest Rate | Average Balance | Weighted Average Interest Rate |
|                          | (Dollars in thousands)   |                                |                 |                                |                 |                                |
| Time deposits            | \$ 2,041,122             | 3.35%                          | \$ 1,608,599    | 2.57%                          | \$ 1,152,281    | 2.54%                          |
| Regular savings and MMDA | 1,158,270                | 1.92                           | 1,092,612       | 1.04                           | 572,842         | 1.15                           |
| Checking accounts:       |                          |                                |                 |                                |                 |                                |
| Interest-bearing         | 419,137                  | 0.32                           | 399,963         | 0.21                           | 318,722         | 0.31                           |
| Noninterest-bearing      | 648,385                  | 0.00                           | 546,128         | 0.00                           | 280,990         | 0.00                           |
|                          | \$ 4,266,914             | 2.16%                          | \$ 3,647,302    | 1.47%                          | \$ 2,324,835    | 1.58%                          |

The following table shows the amounts and remaining maturities of time deposits that had balances of \$100,000 or more at December 31, 2005 and 2004:

|                    | December 31,           |              |
|--------------------|------------------------|--------------|
|                    | 2005                   | 2004         |
|                    | (Dollars in thousands) |              |
| Less than 3 months | \$ 525,623             | \$ 293,748   |
| 3 to 6 months      | 332,184                | 245,928      |
| 6 to 12 months     | 449,559                | 202,773      |
| Over 12 months     | 201,183                | 261,189      |
|                    | \$ 1,508,549           | \$ 1,003,638 |

**Table of Contents**

The following table sets forth the composition of Sterling's deposit accounts at the dates indicated:

|                              | December 31, |                                    |              |                                    |
|------------------------------|--------------|------------------------------------|--------------|------------------------------------|
|                              | 2005         | Percentage<br>of Total<br>Deposits | 2004         | Percentage<br>of Total<br>Deposits |
|                              | Amount       | (Dollars in thousands)             |              | Amount                             |
| Interest-bearing checking    | \$ 432,936   | 9.0                                | \$ 413,217   | 10.7                               |
| Noninterest-bearing checking | 673,934      | 14.0                               | 574,186      | 14.9                               |
| Regular savings              | 187,646      | 3.9                                | 203,487      | 5.3                                |
| MMDA                         | 1,124,387    | 23.4                               | 901,384      | 23.3                               |
| Variable-rate time deposits: |              |                                    |              |                                    |
| 9 to 36 months               | 112,940      | 2.3                                | 142,218      | 3.7                                |
| Fixed-rate time deposits:    |              |                                    |              |                                    |
| 1 to 11 months               | 1,399,372    | 29.1                               | 890,614      | 23.1                               |
| 12 to 35 months              | 462,947      | 9.6                                | 284,223      | 7.4                                |
| 36 to 240 months             | 412,139      | 8.7                                | 453,967      | 11.6                               |
| Total deposits               | \$ 4,806,301 | 100.0                              | \$ 3,863,296 | 100.0                              |

A majority of Sterling's depositors are residents of the states of Washington, Oregon, Idaho and Montana. Sterling has 132 automated teller machines (ATM) to better serve customers in those markets. Customers also can access ATMs operated by other financial institutions. Sterling is a member of The Exchange and the Plus System ATM networks that allow participating customers to deposit or withdraw funds from transaction accounts, MMDA and savings accounts at numerous locations in the United States and internationally.

**Borrowings.** Deposit accounts are Sterling's primary source of funds. Sterling does, however, rely upon advances from the Federal Home Loan Bank Seattle (FHLB Seattle), reverse repurchase agreements and other borrowings to supplement its funding and to meet deposit withdrawal requirements. During the first quarter of 2005, Sterling prepaid \$258.0 million of FHLB Seattle advances, resulting in a net gain on the extinguishment of debt of \$645,000. Other borrowings decreased from December 31, 2004, as Sterling paid off its term note to U.S. Bank. See MD&A Liquidity and Capital Resources.

The FHLB Seattle is part of a system that consists of 12 regional Federal Home Loan Banks each subject to Federal Housing Finance Board supervision and regulation, and that function as a central reserve bank providing credit to financial institutions. As a condition of membership in the FHLB Seattle, Sterling Savings Bank is required to own stock of the FHLB Seattle in an amount determined by a formula based upon the larger of Sterling Savings Bank's total mortgages outstanding or total advances from the FHLB Seattle. At December 31, 2005, Sterling Savings Bank held more than the minimum FHLB Seattle stock ownership requirement. The stock of the FHLB Seattle always has been redeemable at par value, but there can be no assurance that this always will be the case.

As a member of the FHLB Seattle, Sterling Savings Bank can apply for advances on the security of its FHLB Seattle stock and certain of its mortgage loans and other assets (principally securities which are obligations of, or guaranteed by, the United States or its agencies), provided certain standards related to creditworthiness, including a minimum ratio of total capital assets of at least five percent, are met. Each available credit program has its own interest rate and range of maturities. At December 31, 2005, Sterling had advances totaling \$1.44 billion from the FHLB Seattle, which mature from 2006 through 2016 at interest rates ranging from 1.87% to 8.08%. See MD&A Liquidity and Capital Resources and Note 9 of Notes to Consolidated Financial Statements.

Sterling also borrows funds under reverse repurchase agreements with major broker/dealers and financial entities pursuant to which it sells investments (generally, U.S. agency obligations 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 uses these borrowings to supplement deposit gathering for funding the origination of loans. Sterling had \$611.7 million and \$779.0 million in wholesale and retail reverse repurchase

**Table of Contents**

agreements outstanding at December 31, 2005 and 2004, respectively. 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. For additional information regarding reverse repurchase agreements, see MD&A Asset and Liability Management, MD&A Liquidity and Capital Resources and Note 10 of Notes to Consolidated Financial Statements.

**Other Borrowings.** At December 31, 2004, Sterling had a \$19 million variable-rate term note with U.S. Bank, N.A. ( U.S. Bank ). On March 31, 2005, Sterling repaid \$14 million of principal on this borrowing. On April 29, 2005, Sterling repaid the remaining balance of this borrowing.

On May 18, 2005, Sterling entered into a \$40 million variable-rate credit agreement (the Credit Facility ) with Bank of Scotland. Funds can be borrowed for up to one year after the agreement date before the credit line expires. Once funds have been borrowed, Sterling can take up to seven years to repay the principle. Amounts loaned pursuant to the Credit Facility bear Eurodollar interest at the LIBOR rate (as defined in the Credit Facility) plus a specified margin based on Sterling's credit ratings and compliance with the terms of the Credit Facility. The Credit Facility is secured by a majority of the preferred stock of Sterling's wholly owned subsidiary, Sterling Savings Bank. The Credit Facility contains representations and warranties, and negative and affirmative covenants by Sterling, including financial covenants and restrictions on Sterling's ability to take certain actions, such as incur debt, make investments and make acquisitions of other entities. Sterling is obligated to commence repayment of any loan principal on the third anniversary of the date Sterling entered into the Credit Facility, and is permitted to prepay loan principal without penalty. No amounts borrowed and repaid under the Credit Facility may be reborrowed. As of December 31, 2005, no funds had been advanced to Sterling under the Credit Facility. For further details, see Sterling's Form 8-K filed May 20, 2005 on the SEC's website, located at [www.sec.gov](http://www.sec.gov).

At December 31, 2005, Sterling had outstanding \$108.7 million in various series of Trust Preferred Securities issued to investors. See Note 11 of Notes to Consolidated Financial Statements.

The following table sets forth certain information regarding Sterling's short-term borrowings as of and for the periods indicated:

|  | <b>Years Ended December 31,</b> |             |             |
|--|---------------------------------|-------------|-------------|
|  | <b>2005</b>                     | <b>2004</b> | <b>2003</b> |
|  | <b>(Dollars in thousands)</b>   |             |             |
| Maximum amount outstanding at any month-end during the period: |                                 |             |             |
| Short-term reverse repurchase agreements                       | \$821,363                       | \$779,012   | \$285,637   |
| Short-term advances  | 587,719                         | 648,648     | 372,500     |
| Average amount outstanding during the period:                  |                                 |             |             |
| Short-term reverse repurchase agreements                       | \$634,838                       | \$630,057   | \$ 56,518   |
| Short-term advances  | 461,897                         | 517,499     | 197,500     |
| Weighted average interest rate paid during the period:         |                                 |             |             |
| Short-term reverse repurchase agreements                       | 3.23%                           | 2.22%       | 1.82%       |
| Short-term advances  | 3.15%                           | 2.77%       | 2.73%       |
| Weighted average interest rate paid at end of period:          |                                 |             |             |
| Short-term reverse repurchase agreements                       | 3.68%                           | 2.53%       | 1.59%       |
| Short-term advances  | 3.39%                           | 3.36%       | 2.51%       |

**Table of Contents**

The following table sets forth certain information concerning Sterling's outstanding borrowings for the periods indicated:

|   | 2005         |       | December 31,<br>2004             |       | 2003         |       |
|---|--------------|-------|----------------------------------|-------|--------------|-------|
|   | Amount       | %     | Amount<br>(Dollars in thousands) | %     | Amount       | %     |
| FHLB Seattle advances:  |              |       |                                  |       |              |       |
| Short-term  | \$ 670,047   | 30.9  | \$ 562,238                       | 22.1  | \$ 408,685   | 26.8  |
| Long-term   | 773,415      | 35.7  | 1,073,695                        | 42.1  | 617,346      | 40.4  |
| Securities sold subject to reverse repurchase agreements and funds purchased: |              |       |                                  |       |              |       |
| Short-term  | 261,676      | 12.1  | 780,012                          | 30.6  | 288,137      | 18.9  |
| Long-term   | 350,000      | 16.2  | 0                                | 0.0   | 75,000       | 4.9   |
| Floating Rate Notes   |              |       |                                  |       |              |       |
| Due 2006 <sup>(1)</sup>   | 0            | 0.0   | 0                                | 0.0   | 30,000       | 2.0   |
| Term note payable <sup>(2)</sup>  | 0            | 0.0   | 19,000                           | 0.7   | 22,000       | 1.4   |
| Trust Preferred Securities  | 108,707      | 5.0   | 108,685                          | 4.3   | 80,415       | 5.3   |
| Other   | 1,981        | 0.1   | 4,137                            | 0.2   | 5,583        | 0.3   |
| Total borrowings  | \$ 2,165,826 | 100.0 | \$ 2,547,767                     | 100.0 | \$ 1,527,166 | 100.0 |
| Weighted average interest rate at end of period                               |              | 4.03% |                                  | 3.36% |              | 3.40% |

(1) These notes were redeemed in full in December 2004.

(2) These notes were redeemed in full in April 2005.

**Subsidiaries**

Sterling's principal subsidiary is Sterling Savings Bank. Sterling Savings Bank has three principal subsidiaries, which have been previously described: Action Mortgage, INTERVEST and Harbor Financial. Additionally, Sterling and Sterling Savings Bank have the following other wholly owned, direct subsidiaries:

***Sterling Financial Corporation.***

(1) Sterling Capital Trust II (SCT-II) was organized in July 2001 as a Delaware business trust. Sterling owns all the common equity of SCT-II. The sole asset of SCT-II is the Junior Subordinated Debentures-II issued by Sterling. See Note 11 of Notes to Consolidated Financial Statements.

(2)



Sterling Capital Trust III ( SCT-III ) was organized in April 2003 as a Delaware business trust. Sterling owns all the common equity of SCT-III. The sole asset of SCT-III is the Junior Subordinated Debentures-III issued by Sterling. See Note 11 of Notes to Consolidated Financial Statements.

- (3) Sterling Capital Trust IV ( SCT-IV ) was organized in May 2003 as a Delaware business trust. Sterling owns all the common equity of SCT-IV. The sole asset of SCT-IV is the Junior Subordinated Debentures-IV issued by Sterling. See Note 11 of Notes to Consolidated Financial Statements.
- (4) Sterling Capital Statutory Trust V ( SCT-V ) was organized in May 2003 as a Connecticut business trust. Sterling owns all the common equity of SCT-V. The sole asset of SCT-V is the Junior Subordinated Debentures -V issued by Sterling. See Note 11 of Notes to Consolidated Financial Statements.
- (5) Sterling Capital Trust VI ( SCT-VI ) was organized in June 2003 as a Delaware business trust. Sterling owns all the common equity of SCT-VI. The sole asset of SCT-VI is the Junior Subordinated Debentures-VI issued by Sterling. See Note 11 of Notes to Consolidated Financial Statements.
- (6) Klamath First Capital Trust I ( KCT-I ) was organized in July 2001 as a Delaware business trust. Sterling owns all the common equity of KCT-I. The sole asset of KCT-I is the Junior Subordinated Debentures-I issued by KFBI and assumed by Sterling. See Note 11 of Notes to Consolidated Financial Statements.

## **Table of Contents**

(7) Klamath First Capital Trust II ( KCT-II ) was organized in April 2002 as a Delaware business trust. Sterling owns all the common equity of KCT-II. The sole asset of KCT-II is the Junior Subordinated Debentures-II issued by KFBI and assumed by Sterling. See Note 11 of Notes to Consolidated Financial Statements.

(8) Tri-Cities Mortgage Corporation was organized to engage in real estate development.

### ***Sterling Savings Bank.***

(1) The Dime Service Corporation was acquired as part of a merger in February 2003. The corporation is currently inactive.

(2) Evergreen Environmental Development Corporation was organized to engage in real estate development.

(3) Evergreen First Service Corporation owns all of the outstanding capital stock of Harbor Financial, through which Sterling offers tax-deferred annuities, mutual funds and other financial products.

(4) Fidelity Service Corporation acts as a trustee in the reconveyance of deeds of trust originated by Sterling Savings Bank and Action.

(5) Pacific Cascades Financial, Inc. was acquired in January 2004. The corporation acts as trustee in the reconveyance of deeds of trust.

(6) Peter W. Wong Associates, Inc. was organized to offer alternative financial services.

(7) Source Capital Corporation was acquired in September 2001. The corporation was organized to hold and service loans, and is currently inactive.

(8) Source Capital Leasing Corporation was acquired in September 2001, and was organized to engage in corporate leasing.

(9) Tri-West Mortgage, Inc. was organized to engage in mortgage banking, and is currently inactive.

### **Competition**

Sterling faces strong competition, both in attracting deposits and in originating, purchasing and selling loans, from savings and loan associations, mutual savings banks, credit unions, commercial banks and other institutions, many of which have greater resources than Sterling. Sterling also faces strong competition in marketing financial products such as annuities, mutual funds and other financial products and in pursuing acquisition opportunities. Some or all of these competitive businesses operate in Sterling's market areas.

### **Personnel**

As of December 31, 2005, Sterling, including its subsidiaries, had 1,789 full-time equivalent employees. Employees are not represented by a collective bargaining unit. Sterling believes it has good relations with its employees.

### **Environmental Laws**

Environmentally related hazards have become a source of high risk and potentially unlimited liability for financial institutions relative to their loans. Environmentally contaminated properties owned by an institution's borrowers may result in a drastic reduction in the value of the collateral securing the institution's loans to such borrowers, high environmental clean-up costs to the borrower affecting its ability to repay the loans, the subordination of any lien in favor of the institution to a state or federal lien securing clean-up costs, and liability to the institution for clean-up costs if it forecloses on the contaminated property or becomes involved in the management of the borrower. To minimize this risk, Sterling may require an environmental examination and report with respect to the property of any borrower or prospective borrower if circumstances affecting the property indicate a potential for contamination, taking into consideration the potential loss to the institution in relation to the burdens to the borrower. This examination must be performed by an engineering firm experienced in environmental risk studies and acceptable to the institution, with the costs of such examinations and reports being the responsibility of the borrower. These costs may be substantial and

**Table of Contents**

may deter a prospective borrower from entering into a loan transaction with Sterling. Sterling is not aware of any borrower who is currently subject to any environmental investigation or clean-up proceeding that is likely to have a material adverse effect on the financial condition or results of operations of Sterling.

**Regulation**

*The following is not intended to be a complete discussion but is intended to be a summary of some of the more significant provisions of laws applicable to Sterling and its subsidiaries. This regulatory framework is intended to protect depositors, federal deposit insurance funds and the banking system as a whole, and not to protect security holders. To the extent that the information describes statutory and regulatory provisions, it is qualified in its entirety by reference to those provisions. Further, such statutes, regulations and policies are continually under review by Congress and state legislatures, and federal and state regulatory agencies. A change in statutes, regulations or regulatory policies applicable to Sterling, including changes in interpretation or implementation thereof, could have a material effect on Sterling's business.*

**General**

Sterling is a bank holding company and as such is subject to comprehensive examination and regulation by the Board of Governors of the Federal Reserve System (the Federal Reserve Board). Sterling Savings Bank is a Washington State-chartered commercial bank and its deposits are insured by the FDIC. Sterling Savings Bank is subject to comprehensive regulation, examination and supervision by the FDIC and the Washington Department of Financial Institutions, Division of Banks. Furthermore, certain transactions and savings deposits are subject to regulations and controls promulgated by the Federal Reserve Board. Sterling's nonbank subsidiaries are also subject to regulation by the Federal Reserve Board and other applicable federal and state agencies for the states in which they conduct business.

These laws and regulations could restrict Sterling's ability to diversify into other areas of financial services, acquire depository institutions, and pay dividends on its capital stock. Sterling may also be required to provide financial support to one or more of its subsidiary banks, maintain capital balances in excess of those desired by management, and pay higher deposit insurance premiums as a result of a general deterioration in the financial condition of depository institutions.

**Bank Holding Company Regulation**

**The Fair and Accurate Credit Transactions Act.** In December 2003, the Fair and Accurate Credit Transactions Act of 2003 (the FACT) was signed into law. The FACT includes many provisions concerning national credit reporting standards and permits consumers, including Sterling's customers, to opt out of information sharing among affiliated companies for marketing purposes. The FACT also requires financial institutions to provide consumers certain information regarding the consumer's credit score. Additionally, financial institutions must notify their customers if they report negative information about them to credit bureaus or if the credit terms offered to a customer are materially less favorable than the most favorable terms offered to a substantial portion of customers because of information in the customer's credit report. The FACT also contains provisions intended to help detect identity theft.

**The Sarbanes-Oxley Act.** In July 2002, the Sarbanes-Oxley Act of 2002 (the SOA) was enacted in response to public concerns regarding corporate accountability. The stated goals of the SOA are to increase corporate responsibility, to provide for enhanced penalties for accounting and auditing improprieties at publicly traded companies and to protect investors by improving the accuracy and reliability of corporate disclosures pursuant to the securities laws. The SOA represents a comprehensive revision of laws affecting corporate governance, accounting obligations and corporate reporting. The SOA generally applies to all companies that file or are required to file periodic reports with the SEC under the Securities Exchange Act of 1934, as amended (Exchange Act). The SOA includes new disclosure requirements and corporate governance rules, requires the SEC and securities exchanges to adopt extensive additional disclosure, corporate governance and other related rules, and mandates further studies of certain issues by the SEC and the Comptroller General. In particular, the SOA establishes: new requirements for audit committees; additional responsibilities regarding financial statements of reporting companies; new standards for auditors and regulation of audits; increased disclosure and reporting obligations for a reporting company and its directors and executive officers; and new civil and criminal penalties for violation of the securities laws. The SEC has enacted rules to implement various of the provisions with respect to, among other matters,

disclosure in periodic filings pursuant to the Exchange Act.

**Table of Contents**

***The U.S.A. Patriot Act.*** In December 2001, the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the Patriot Act ) became effective. The Patriot Act is designed to combat money laundering and terrorist financing while protecting the U.S. financial system. The Patriot Act imposes enhanced policy, record keeping and due diligence requirements on domestic financial institutions. The Patriot Act also amended the Bank Secrecy Act to facilitate access to customer account information by government officials while immunizing banks from liability for releasing such information.

***The Gramm-Leach-Bliley Act.*** In November 1999, the Gramm-Leach-Bliley Act (the GLBA ) was enacted. The GLBA is also known as the Financial Services Modernization Act due to its sweeping overhaul of the financial services industry. Enactment of the GLBA allows banks, securities firms and insurance companies to affiliate. Now financial institutions can act as financial supermarkets offering customers one stop shopping for bank accounts, insurance policies and securities transactions.

The GLBA, among other things, provides customers with greater financial privacy by requiring financial institutions to safeguard their nonpublic personal information. Financial institutions must advise customers of their policies regarding sharing nonpublic personal information with non-affiliated third parties and allow customers to opt-out of such sharing (subject to several exceptions related mainly to processing customer-initiated transactions and compliance with current law).

***The Riegle-Neal Interstate Banking and Branching Efficiency Act.*** The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (the Interstate Act ) permits nationwide interstate banking and branching under certain circumstances. This legislation generally authorizes interstate branching and relaxes federal law restrictions on interstate banking. Currently, bank holding companies may purchase banks in any state, and states may not prohibit these purchases. Additionally, banks are permitted to merge with banks in other states, as long as the home state of neither merging bank has opted out under the legislation. The Interstate Act requires regulators to consult with community organizations before permitting an interstate institution to close a branch in a low-income area.

Washington enacted opting in legislation in accordance with the Interstate Act, allowing banks to engage in interstate merger transactions, subject to certain aging requirements. Washington restricts an out-of-state bank from opening de novo branches. However, once an out-of-state bank has acquired a bank within the state, either through merger or acquisition of all or substantially all of the bank's assets, the out-of-state bank may open additional branches within the state.

***The Bank Holding Company Act.*** As a bank holding company, Sterling is governed by The Bank Holding Company Act of 1956, as amended (the BHCA ), and is therefore subject to supervision and examination by the Federal Reserve Board. Sterling files annual reports of operations with the Federal Reserve Board.

In general, the BHCA limits bank holding company business to owning or controlling banks and engaging in other banking-related activities. Bank holding companies must obtain the Federal Reserve Board's approval before they: (1) acquire direct or indirect ownership or control of any voting shares of any bank that results in total ownership or control, directly or indirectly, of more than 5 percent of the voting shares of such bank; (2) merge or consolidate with another bank holding company; or (3) acquire substantially all of the assets of any additional banks. Subject to certain state laws, such as age and contingency restrictions, a bank holding company that is adequately capitalized and adequately managed may acquire the assets of both in-state and out-of-state banks. With certain exceptions, the BHCA prohibits bank holding companies from acquiring direct or indirect ownership or control of voting shares in any company that is not a bank or a bank holding company unless the Federal Reserve Board determines that the activities of such company are incidental or closely related to the business of banking. If a bank holding company is well-capitalized and meets certain criteria specified by the Federal Reserve Board, it may engage de novo in certain permissible non-banking activities without prior Federal Reserve Board approval.

***The Change in Bank Control Act.*** Pursuant to The Change in Bank Control Act of 1978, as amended, a person (or group of persons acting in concert) acquiring control of a bank holding company is required to provide the Federal Reserve Board with 60 days prior written notice of the proposed acquisition. Following receipt of this notice, the Federal Reserve Board has 60 days within which to issue a notice disapproving the proposed acquisition, but the Federal



**Table of Contents**

Reserve Board may extend this time period for up to another 30 days. An acquisition may be completed before expiration of the disapproval period if the Federal Reserve Board issues written notice of its intent not to disapprove the transaction. In addition, any company must obtain the Federal Reserve Board's approval before acquiring 25% (5% if the company is a bank holding company) or more of the outstanding shares or otherwise obtaining control over Sterling.

***The Federal Reserve Act.*** Sterling and its subsidiaries are deemed affiliates within the meaning of the Federal Reserve Act, and transactions between affiliates are subject to certain restrictions. Accordingly, Sterling and its subsidiaries must comply with Sections 23A and 23B of the Federal Reserve Act. Generally, Sections 23A and 23B (1) limit the extent to which a financial institution or its subsidiaries may engage in covered transactions with an affiliate, as defined, to an amount equal to 10% of such institution's capital and surplus and an aggregate limit on all such transactions with all affiliates to an amount equal to 20% of such capital and surplus, and (2) require all transactions with an affiliate, whether or not covered transactions, to be on terms substantially the same, or at least as favorable to the institution or subsidiary, as those provided to a non-affiliate. The term covered transaction includes the making of loans, purchase of assets, issuance of a guarantee and other similar types of transactions.

***Transactions with Affiliates.*** Subsidiary banks of a bank holding company are subject to restrictions imposed by the Federal Reserve Act on extensions of credit to the holding company or its subsidiaries, on investments in their securities, and on the use of their securities as collateral for loans to any borrower. These regulations and restrictions may limit Sterling's ability to obtain funds from its banking subsidiaries for its cash needs, including funds for payment of dividends, interest and operational expenses.

***Tying Arrangements.*** Sterling is prohibited from engaging in certain tie-in arrangements in connection with any extension of credit, sale or lease of property or furnishing of services. For example, with certain exceptions, neither Sterling nor its subsidiaries may condition an extension of credit to a customer on either (1) a requirement that the customer obtain additional services provided by Sterling or (2) an agreement by the customer to refrain from obtaining other services from a competitor.

***Support of Subsidiary Banks.*** Under Federal Reserve policy, Sterling is expected to act as a source of financial and managerial strength to its banking subsidiary. This means that Sterling is required to commit, as necessary, resources to support Sterling Savings Bank. Any capital loans a bank holding company makes to its subsidiary banks are subordinate to deposits and to certain other indebtedness of those subsidiary banks.

***Federal and State Regulation of Banking Activities***

***General.*** The deposits of Sterling Savings Bank are insured by the FDIC. As a result, it is subject to supervision and regulation by the FDIC as well as the Washington Department of Financial Institutions, Division of Banks. These agencies have the authority to prohibit banks from engaging in what they believe constitute unsafe or unsound banking practices.

***Community Reinvestment.*** The Community Reinvestment Act requires that, in connection with examinations of financial institutions within their jurisdiction, the Federal Reserve or the FDIC evaluate the record of the financial institution in meeting the credit needs of its local communities, including low and moderate income neighborhoods, consistent with the safe and sound operation of the institution. These factors are also considered in evaluating mergers, acquisitions and applications to open a branch or facility.

***Insider Credit Transactions.*** Banks are also subject to certain restrictions imposed by the Federal Reserve Act on extensions of credit to executive officers, directors, principal shareholders or any related interests of such persons. Extensions of credit (1) must be made on substantially the same terms, including interest rates and collateral as, and follow credit underwriting procedures that are not less stringent than, those prevailing at the time for comparable transactions with persons not covered above and who are not employees, and (2) must not involve more than the normal risk of repayment or present other unfavorable features. Banks are also subject to certain lending limits and restrictions on overdrafts to insiders. A violation of these restrictions may result in the assessment of substantial civil monetary penalties, the imposition of a cease and desist order, and other regulatory sanctions.

**Table of Contents**

**Regulation of Management.** Federal law: (1) sets forth circumstances under which officers or directors of a bank may be removed by the institution's federal supervisory agency; (2) places restraints on lending by a bank to its executive officers, directors, principal shareholders, and their related interests; and (3) prohibits management personnel of a bank from serving as a director or in a management position of another financial institution whose assets exceed a specified amount or which has an office within a specified geographic area.

**Safety and Soundness Standards.** The Federal Deposit Insurance Corporation Act of 1991 requires the FDIC to impose upon banks certain non-capital safety and soundness standards. These standards cover, among other things, internal controls, information systems, internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth, compensation and benefits. Additional standards apply to asset quality, earnings and stock valuation. An institution that fails to meet these standards must develop a plan acceptable to its regulators, specifying the steps that the institution will take to meet the standards. Failure to submit or implement such a plan may subject the institution to regulatory sanctions.

**Lending Restrictions and Disclosure Requirements.** The Federal Reserve Board has adopted amendments to the Home Ownership and Equity Protection Act of 1994 ( HOEPA ), which expand the protections of HOEPA to cover more transactions and prohibit certain practices deemed harmful to borrowers. If a loan qualifies as a HOEPA loan, certain practices and terms on high-cost mortgages are restricted and require special consumer disclosures. The interest rate trigger on first-time liens used to determine whether a loan qualifies as a HOEPA loan has been lowered from 10% to 8% and the cost of single-premium credit insurance products has been added to the points and fees test. As a result, more of Sterling's loans are expected to be subject to HOEPA restrictions and disclosure requirements.

**Deposit Insurance Assessments.** Through the Bank Insurance Fund ( BIF ) and the Savings Association Insurance Fund ( SAIF ), the FDIC insures the deposits of Sterling Savings Bank up to prescribed limits for each depositor. The amount of FDIC assessments paid by a BIF and SAIF member institution is based on its relative risk of default as measured by regulatory capital ratios and other factors. Specifically, the assessment rate is based on the institution's capitalization risk category and supervisory subgroup category. An institution's capitalization risk category is based on the FDIC's determination of whether the institution is well capitalized, adequately capitalized or less than adequately capitalized. An institution's supervisory subgroup category is based on the FDIC's assessment of the financial condition of the institution and the probability that FDIC intervention or other corrective action will be required.

The BIF and SAIF assessment rate currently ranges from zero to 27 cents per \$100 of domestic deposits. The BIF and SAIF assessment rate for Sterling Savings Bank, as a well capitalized institution, currently is zero. The FDIC may increase or decrease the assessment rate schedule on a semi-annual basis. An increase in the assessment rate could have a material adverse effect on Sterling's earnings, depending on the amount of the increase. The FDIC is authorized to terminate a depository institution's deposit insurance upon a finding by the FDIC that the institution's financial condition is unsafe or unsound or that the institution has engaged in unsafe or unsound practices or has violated any applicable rule, regulation, order or condition enacted or imposed by the institution's regulatory agency. The termination of deposit insurance for Sterling's subsidiary, Sterling Savings Bank, could have a material adverse effect on Sterling's earnings.

All FDIC-insured depository institutions must pay an annual assessment to provide funds for the payment of interest on bonds issued by the Financing Corporation, a federal corporation chartered under the authority of the Federal Housing Finance Board. The bonds (commonly referred to as FICO bonds) were issued to capitalize the Federal Savings and Loan Insurance Corporation. FDIC-insured depository institutions paid approximately 1.39 cents per \$100 of BIF- assessable deposits in 2005. The FDIC established the FICO assessment rate effective for the first quarter of 2006 at approximately 1.32 cents annually per \$100 of assessable deposits.

On February 15, 2006, President Bush signed the Federal Deposit Insurance Reform Conforming Amendments Act of 2005, which contains comprehensive deposit insurance reform provisions. This bill provides for legislative reforms to modernize the federal deposit insurance system. Among other things, provisions in the modernization legislation would: 1) merge the BIF and SAIF into a new Deposit Insurance Fund; 2) index the \$100,000 deposit insurance limit to inflation beginning in 2010 and every succeeding five years while giving the FDIC authority to determine whether raising the standard maximum deposit insurance is warranted; 3) increase the deposit insurance limit for certain retirement accounts to \$250,000, with such limit indexed to inflation; 4) allow the FDIC Board to set assessments; and



5) require final regulations to be issued no later than 270 days after enactment. The final regulations implementing these changes have not yet been issued, and are not expected to have a material adverse effect on Sterling during 2006.

**Table of Contents**

**Dividends Restrictions.** Sterling is a legal entity separate and distinct from its subsidiary bank and other subsidiaries. Its principal source of funds to pay dividends on its common and preferred stock and principal and interest on its debt is dividends from its subsidiaries. Various federal and state statutory provisions and regulations limit the amount of dividends Sterling Savings Bank and certain other subsidiaries may pay without regulatory approval.

Federal bank regulatory agencies have the authority to prohibit Sterling Savings Bank from engaging in unsafe or unsound practices in conducting its business. The payment of dividends, depending on Sterling Savings Bank's financial condition, could be deemed an unsafe or unsound practice. The ability of Sterling Savings Bank to pay dividends in the future is currently, and could be further, influenced by bank regulatory policies and capital guidelines.

**Federal Reserve System.** Sterling Savings Bank is subject to various regulations promulgated by the Fed, including, among others, Regulation B (Equal Credit Opportunity), Regulation D (Reserves), Regulation E (Electronic Fund Transfers), Regulation Z (Truth in Lending), Regulation CC (Availability of Funds) and Regulation DD (Truth in Savings). Regulation D requires non-interest-bearing reserve maintenance in the form of either vault cash or funds on deposit at the Federal Reserve Bank of San Francisco or another designated depository institution in an amount calculated by formula. The balances maintained to meet the reserve requirements imposed by the Fed may be used to satisfy liquidity requirements. As of December 31, 2005, Sterling Savings Bank met these requirements.

**Federal Taxation.** Sterling is subject to federal income taxation under the Internal Revenue Code of 1986, as amended, in the same manner as other corporations. Sterling files consolidated federal income tax returns on the accrual basis. See Note 12 of Notes to Consolidated Financial Statements.

**State Law and Regulation.** Sterling Savings Bank, as a Washington State-chartered institution, is subject to regulation by the Washington Supervisor of the Washington Department of Financial Institutions, which conducts regular examinations to ensure that Sterling Savings Bank's operations and policies conform with sound industry practice. The liquidity and other requirements set by the Washington Supervisor are generally no stricter than the liquidity and other requirements set by the Federal Reserve Board. State law regulates the amount of credit that can be extended to any one person or marital community and the amount of money that can be invested in any one property. Without the Washington Supervisor's approval, Sterling Savings Bank currently cannot extend credit to any one person or marital community in an amount greater than 2.5% of Sterling Savings Bank's total assets. State law also regulates the types of loans Sterling Savings Bank can make. Without the Washington Supervisor's approval, Sterling Savings Bank cannot currently invest more than 10% of its total assets in other corporations. Sterling Savings Bank also operates branches within the states of Oregon, Idaho and Montana and therefore its operations in these states are subject to the supervision of the Oregon Department of Consumer and Business Services, the Idaho Department of Finance and the Montana Department of Finance, as applicable. Sterling and its subsidiaries are also required to comply with applicable laws and regulations for activities in Arizona, California and Utah.

**Capital Adequacy**

**Regulatory Capital Guidelines.** Federal bank regulatory agencies use capital adequacy guidelines in the examination and regulation of bank holding companies and banks. The guidelines are risk-based, meaning that they are designed to make capital requirements more sensitive to differences in risk profiles among banks and bank holding companies.

**Tier I and Tier II Capital.** Under the guidelines, an institution's capital is divided into two broad categories, Tier I capital and Tier II capital. Tier I capital generally consists of common stockholders' equity, surplus, undivided profits, and trust preferred obligations. Tier II capital generally consists of the allowance for loan losses and hybrid capital instruments. The sum of Tier I capital and Tier II capital represents an institution's total capital. The guidelines require that at least 50% of an institution's total capital consist of Tier I capital.

**Risk-based Capital Ratios.** The adequacy of an institution's capital is gauged primarily with reference to the institution's risk-weighted assets. The guidelines assign risk weightings to an institution's assets in an effort to quantify the relative risk of each asset and to determine the minimum capital required to support that risk. An institution's risk-weighted assets are then compared with its Tier I capital and total capital to arrive at a Tier I risk-based ratio and a total risk-based ratio, respectively. The guidelines provide that an institution must have a minimum Tier I risk-based ratio of 4% and a minimum total risk-based ratio of 8%.

**Table of Contents**

**Leverage Ratio.** The guidelines also employ a leverage ratio, which is Tier I capital as a percentage of total assets, less intangibles. The principal objective of the leverage ratio is to constrain the maximum degree to which a bank holding company may leverage its equity capital base. The minimum leverage ratio is 3%; however, for all but the most highly rated bank holding companies and for bank holding companies seeking to expand, regulators expect an additional cushion of at least 1% to 2%.

**Prompt Corrective Action.** Under the guidelines, an institution is assigned to one of five capital categories depending on its total risk-based capital ratio, Tier I risk-based capital ratio, and leverage ratio, together with certain subjective factors. The categories range from well capitalized to critically undercapitalized. Institutions that are undercapitalized or lower are subject to certain mandatory supervisory corrective actions.

## **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:

the 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.

### **Where You Can Find More Information**

The periodic reports Sterling files with the SEC are available on Sterling's website at [www.sterlingsavingsbank.com](http://www.sterlingsavingsbank.com) after the reports are filed with the SEC. The SEC maintains a website located at [www.sec.gov](http://www.sec.gov) that also contains this information. The information on Sterling's website and the SEC's website is not part of this annual report on Form 10-K. **Sterling will provide you with copies of these reports, without charge, upon request made to:**

Investor Relations  
Sterling Financial Corporation  
111 North Wall Street

Spokane, Washington 99201

(509) 458-3711

25

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**Table of Contents**

**Item 1A. Risk Factors**

*Set forth below and elsewhere in this Annual Report on Form 10-K and in other documents Sterling files with the SEC are risks and uncertainties that could cause actual results to differ materially from the results contemplated by the forward-looking statements contained in this Annual Report on Form 10-K.*

**As a bank holding company, Sterling's earnings are dependent upon the performance of its bank and non-bank subsidiaries as well as by business, economic and political conditions.**

Sterling is a legal entity separate and distinct from Sterling Savings Bank, although the principal source of its cash is dividends from Sterling Savings Bank. Sterling's right to participate in the assets of any subsidiary upon such subsidiary's liquidation, reorganization or otherwise will be subject to the claims of the subsidiary's creditors, which will take priority except to the extent that Sterling may be a creditor with a recognized claim.

Sterling Savings Bank is also subject to restrictions under federal law which limit the transfer of funds to Sterling or to other affiliates, whether in the form of loans, extensions of credit, investments, asset purchases or otherwise. Such transfers by Sterling Savings Bank to Sterling or any other affiliate are limited in amount to 10% of Sterling Savings Bank's capital and surplus. Furthermore, such loans and extensions of credit are required to be collateralized.

Earnings are impacted by business and economic conditions in the United States and abroad. These conditions include short-term and long-term interest rates, inflation, monetary supply, fluctuations in both debt and equity capital markets, and the strength of the U.S. economy and the local economies in which Sterling operates. Business and economic conditions that negatively impact household or corporate incomes could decrease the demand for Sterling products and increase the number of customers who fail to pay their loans.

**A downturn in the local economies or real estate markets could negatively impact Sterling's banking business.**

A downturn in the local economies or real estate markets could negatively impact Sterling's banking business. Because Sterling primarily serves individuals and businesses located in the Pacific Northwest, a significant portion of its total loan portfolio is originated in the Pacific Northwest or secured by Pacific Northwest real estate or other assets. As a result of this geographic concentration the ability of customers to repay their loans, and consequently Sterling's results, are impacted by the economic and business conditions in the Pacific Northwest, in particular in the metropolitan areas of Seattle, Washington, Portland, Oregon, Boise, Idaho, Sacramento, California and Phoenix, Arizona. Any adverse economic or business developments or natural disasters in these areas could cause uninsured damage and other loss of value to real estate that secures Sterling loans or could negatively affect the ability of borrowers to make payments of principal and interest on the underlying loans. In the event of such adverse development or natural disaster, Sterling's results of operations or financial condition could be adversely affected.

Furthermore, current uncertain geopolitical trends and negative economic trends, including uncertainty regarding economic growth and increased unemployment, may negatively impact businesses in Sterling's markets. While the short-term and long-term effects of these events remain uncertain, they could adversely affect general economic conditions, consumer confidence, market liquidity or result in changes in interest rates, any of which could have a negative impact on banking business.

**Sterling has shifted its focus to community banking.**

Sterling is increasing its business banking, consumer and construction lending while placing an increased emphasis on attracting greater volumes of retail deposits. Business banking, consumer and construction loans generally produce higher yields than residential mortgage loans. Such loans, however, generally involve a higher degree of risk than the financing of residential real estate, primarily because the collateral may be difficult to obtain or liquidate in the event of default. Construction lending is subject to risks such as construction delays, cost overruns, insufficient collateral and the inability to obtain permanent financing in a timely manner. Business banking and construction loans are more expensive to originate than residential mortgage loans. As a result, Sterling's operating expenses are likely to increase as Sterling increases its lending in these areas. Additionally, Sterling is likely to experience higher levels of loan losses than it would on residential mortgage loans. There can be no assurance that Sterling's emphasis on community banking will be successful or that any increase in the yields on business banking, consumer and construction loans will offset higher levels of expense and losses on such loans.

**Table of Contents**

**Sterling's loan originations are highly concentrated in certain types of loans.**

Sterling's loans, with limited exceptions, are secured by either, real estate, marketable securities or corporate assets. A significant portion of Sterling's loans are residential construction loans. Sterling's ability to continue to originate such loans may be impaired by adverse changes in local and regional economic conditions in the real estate markets, or by acts of nature. Due to the concentration of real estate collateral, these events could have a material adverse impact on the value of the collateral, resulting in losses or delinquencies. Sterling's residential mortgage and home equity loans are primarily secured by residential property in the Pacific Northwest. As a result, conditions in the real estate markets specifically, and the Pacific Northwest economy generally, can materially impact the ability of its borrowers to repay their loans and affect the value of the collateral securing these loans. Customer demand for loans secured by real estate could be reduced by a weaker economy, an increase in unemployment, a decrease in real estate values or an increase in interest rates.

At December 31, 2005, approximately 21% of Sterling Savings Bank's total loan portfolio consisted of construction loans, approximately 23% of which were for speculative endeavors. A reduction in the demand for new construction could have a negative impact on the Bank and therefore on Sterling. Additionally, 23% of the Bank's loan portfolio consisted of multifamily residential and commercial property loans at December 31, 2005.

**Sterling's earnings are significantly affected by the fiscal and monetary policies of the federal government and the governments of the states in which it operates.**

The Board of Governors of the Federal Reserve System, also known as the Federal Reserve Board, regulates the supply of money and credit in the United States. Its policies determine in large part our cost of funds for lending and investing and the return we earn on those loans and investments, both of which impact net interest margin, and can materially affect the value of financial instruments such as debt securities and mortgage servicing rights. Its policies also can affect our borrowers, potentially increasing the risk that they may fail to repay their loans. Changes in Federal Reserve Board policies are beyond our control and hard to predict or anticipate.

The amount of income taxes that Sterling is required to pay on its earnings is based on federal and state legislation and regulations. Sterling provided for current and deferred taxes in its financial statements, based on its results of operations, business activity, legal structure and interpretation of tax statutes. Sterling may take filing positions or follow tax strategies that may be subject to challenge. Sterling's net income and earnings per share may be reduced if a federal, state, or local authority assessed charges for taxes that have not been provided for in its consolidated financial statements. There can be no assurance that Sterling will achieve its effective tax rate or that taxing authorities will not change tax legislation, challenge filing positions, or assess taxes and interest charges.

**Changes in market interest rates could adversely affect Sterling's earnings.**

Sterling's earnings are impacted by changing market interest rates. Changes in market interest rates impact the level of loans, deposits and investments, the credit profile of existing loans and the rates received on loans and investment securities and the rates paid on deposits and borrowings. One of Sterling's primary sources of income from operations is net interest income, which is equal to the difference between the interest income received on interest-earning assets (usually, loans and investment securities) and the interest expense incurred in connection with interest-bearing liabilities (usually, deposits and borrowings). These rates are highly sensitive to many factors beyond our control, including general economic conditions, both domestic and foreign, and the monetary and fiscal policies of various governmental and regulatory authorities. Net interest income can be affected significantly by changes in market interest rates. Changes in relative interest rates may reduce net interest income as the difference between interest income and interest expenses decreases.

Interest rates are currently rising and if interest rates continue to rise, the amount of interest Sterling pays on deposits and borrowings could increase more quickly than the amount of interest Sterling receives on its loans, mortgage-related securities and investment securities. This could cause Sterling profits to decrease. Rising interest rates would likely reduce the value of Sterling's mortgage-related securities and investment securities and may decrease demand for loans and make it more difficult for borrowers to repay their loans. Increasing market interest rates may also depress property values, which could affect the value of collateral securing Sterling loans.

## **Table of Contents**

An increase in interest rates could also have a negative impact on Sterling's results of operations by reducing the ability of borrowers to repay their current loan obligations. These circumstances could not only result in increased loan defaults, foreclosures and write-offs, but also necessitate further increases to the allowances for loan losses. In addition, fluctuations in interest rates may result in disintermediation, which is the flow of funds away from depository institutions into direct investments that pay a higher rate of return and may affect the value of Sterling investment securities and other interest-earning assets.

### **Sterling's cost of funds may increase as a result of general economic conditions, interest rates or competitive pressures.**

Sterling's cost of funds may increase because of general economic conditions, unfavorable conditions in the capital markets, interest rates and competitive pressures. Sterling has traditionally obtained funds principally through deposits and borrowings. As a general matter, deposits are a cheaper source of funds than borrowings, because interest rates paid for deposits are typically less than interest rates charged for borrowings. If, as a result of general economic conditions, market interest rates, competitive pressures, or other factors, Sterling's level of deposits decreases relative to its overall banking operation, Sterling may have to rely more heavily on borrowings as a source of funds in the future, which may negatively impact net interest margin.

### **Competition may adversely affect Sterling's ability to attract and retain customers at current levels.**

The banking and financial services businesses in Sterling's market areas are highly competitive. Competition in the banking, mortgage and finance industries may limit Sterling's ability to attract and retain customers. Sterling faces competition from other banking institutions, savings banks, credit unions and other financial institutions. Sterling also competes with non-bank financial service companies within the states that it serves and out of state financial intermediaries that have opened loan production offices or that solicit deposits in its market areas. There also has been a general consolidation of financial institutions in recent years, which results in new competitors and larger competitors in Sterling's market areas.

In particular, Sterling's competitors include major financial companies whose greater resources may provide them a marketplace advantage. Areas of competition include interest rates for loans and deposits, efforts to obtain deposits and the range and quality of services provided. Because Sterling has fewer financial and other resources than larger institutions with which it competes, Sterling may be limited in its ability to attract customers. In addition, some of the current commercial banking customers may seek alternative banking sources as they develop needs for credit facilities larger than Sterling can accommodate. If Sterling is unable to attract and retain customers, it may be unable to continue its loan and deposit growth, and its results of operations and financial condition may otherwise be negatively impacted.

### **Sterling may not be able to successfully implement its internal growth strategy.**

Sterling has pursued and intends to continue to pursue an internal growth strategy, the success of which will depend primarily on generating an increasing level of loans and deposits at acceptable risk levels and terms without proportionate increases in non-interest expenses. There can be no assurance that Sterling will be successful in implementing its internal growth strategy. Furthermore, the success of Sterling's growth strategy will depend on maintaining sufficient regulatory capital levels and on continued favorable economic conditions in the Pacific Northwest.

### **There are risks associated with potential acquisitions.**

Sterling may make opportunistic acquisitions of other banks or financial institutions from time to time that further its business strategy, such as the recently announced pending acquisition of Lynnwood Financial Group, Inc. These acquisitions could involve numerous risks including lower than expected performance or higher than expected costs, difficulties in the integration of operations, services, products and personnel, the diversion of management's attention from other business concerns, changes in relationships with customers and the potential loss of key employees. Any acquisitions will be subject to regulatory approval, and there can be no assurance that Sterling will be able to obtain such approvals. Sterling may not be successful in identifying further acquisition candidates, integrating acquired institutions or preventing deposit erosion or loan quality deterioration at acquired institutions. Competition for acquisitions in Sterling's market area is highly competitive, and Sterling may not be able to acquire other institutions on attractive terms. There can be no assurance that Sterling will be successful in completing future acquisitions, or if



such transactions are completed, that Sterling will be successful in integrating acquired businesses into our operations. Sterling's ability to grow may be limited if it is unable to successfully make future acquisitions.

**Table of Contents**

**Sterling may not be able to replace key members of management or attract and retain qualified relationship managers in the future.**

Sterling depends on the services of existing management to carry out its business and investment strategies. As Sterling expands, it will need to continue to attract and retain additional management and other qualified staff. In particular, because Sterling plans to continue to expand its locations, products and services, Sterling will need to continue to attract and retain qualified banking personnel and investment advisors. Competition for such personnel is significant in Sterling's geographic market areas. The loss of the services of any management personnel, or the inability to recruit and retain qualified personnel in the future, could have an adverse effect on our results of operations, financial conditions and prospects.

**Defaults may negatively impact Sterling's business.**

Increased delinquencies or loan defaults by Sterling's customers may negatively impact business. A borrower's default on its obligations under one or more loans may result in lost principal and interest income and increased operating expenses as a result of the allocation of management time and resources to the collection and workout of the loan. If collection efforts are unsuccessful or acceptable workout arrangements cannot be reached, Sterling may have to charge-off all or a part of the loan. In such situations, Sterling may acquire any real estate or other assets, if any, that secure the loan through foreclosure or other similar available remedies. The amount owed under the defaulted loan may exceed the value of the assets acquired.

**The allowance for loan losses may be inadequate.**

Sterling loan customers may not repay their loans according to the terms of the loans, and the collateral securing the payment of these loans may be insufficient to pay any remaining loan balance. Sterling therefore may experience significant loan losses, which could have a material adverse effect on its operating results.

Sterling makes various assumptions and judgments about the collectibility of its loan portfolio, including the creditworthiness of its borrowers and the value of the real estate and other assets serving as collateral for the repayment of many of Sterling's loans. Sterling relies on its loan quality reviews, experience and evaluation of economic conditions, among other factors, in determining the amount of the allowance for loan losses. If Sterling's assumptions prove to be incorrect, its allowance for loan losses may not be sufficient to cover losses inherent in the loan portfolio, resulting in additions to Sterling's allowance. Increases in this allowance result in an expense for the period. If, as a result of general economic conditions or a decrease in asset quality, management determines that additional increases in the allowance for loan losses are necessary, Sterling may incur additional expenses.

Sterling's loans are primarily secured by real estate, including a concentration of properties located in the Pacific Northwest. If an earthquake, volcano eruption or other natural disaster were to occur in one of the major market areas, loan losses could occur that are not incorporated in the existing allowance for loan losses.

**Sterling is expanding its lending activities in riskier areas.**

Sterling has identified commercial real estate, commercial business and consumer loans as areas for increased lending emphasis. While increased lending diversification is expected to increase interest income, non-residential loans carry greater risk of payment default than residential real estate loans. As the volume of these loans increase, credit risk increases. In the event of substantial borrower defaults, Sterling's provision for loan losses would increase and therefore, earnings would be reduced.

**Sterling operations could be interrupted if its third-party service providers experience difficulty, terminate their services or fail to comply with banking regulations.**

## **Table of Contents**

Sterling depends, and will continue to depend, to a significant extent, on a number of relationships with third-party service providers. Specifically, Sterling receives core systems processing, essential web hosting and other Internet systems and deposit and other processing services from third-party service providers. If these third-party service providers experience difficulties or terminate their services and Sterling is unable to replace them with other service providers, its operations could be interrupted. If an interruption were to continue for a significant period of time, business, financial condition and results of operations could be materially adversely affected.

### **Sterling's internal control systems could fail to detect certain events.**

Sterling is subject to certain operations risks, including but not limited to data processing system failures and errors and customer or employee fraud. Sterling maintains a system of internal controls to mitigate against such occurrences and maintain insurance coverage for such risks, but should such an event occur that is not prevented or detected by Sterling's internal controls, uninsured or in excess of applicable insurance limits, it could have a significant adverse impact on its business, financial condition or results of operations.

### **The network and computer systems on which Sterling depends could fail or experience a security breach.**

Sterling's computer systems could be vulnerable to unforeseen problems. Because Sterling conducts part of its business over the Internet and outsources several critical functions to third parties, operations will depend on the ability, as well as that of third-party service providers, to protect computer systems and network infrastructure against damage from fire, power loss, telecommunications failure, physical break-ins or similar catastrophic events. Any damage or failure that causes interruptions in operations could have a material adverse effect on business, financial condition and results of operations.

In addition, a significant barrier to online financial transactions is the secure transmission of confidential information over public networks. Sterling's Internet banking system relies on encryption and authentication technology to provide the security and authentication necessary to effect secure transmission of confidential information. Advances in computer capabilities, new discoveries in the field of cryptography or other developments could result in a compromise or breach of the algorithms its third-party service providers use to protect customer transaction data. If any such compromise of security were to occur, it could have a material adverse effect on Sterling's business, financial condition and results of operations.

### **Sterling could be held responsible for environmental liabilities of properties acquired through foreclosure.**

If Sterling is forced to foreclose on a defaulted mortgage loan to recover its investment, it may be subject to environmental liabilities related to the underlying real property. Hazardous substances or wastes, contaminants, pollutants or sources thereof may be discovered on properties during its ownership or after a sale to a third party. The amount of environmental liability could exceed the value of real property. There can be no assurance that Sterling would not be fully liable for the entire cost of any removal and clean-up on an acquired property, that the cost of removal and clean-up would not exceed the value of the property, or that costs could be recovered from any third party. In addition, Sterling may find it difficult or impossible to sell the property prior to or following any environmental remediation.

### **Sterling's banking business is highly regulated.**

State-chartered banks operate in a highly regulated environment and are subject to supervision and examination by federal and state regulatory agencies. As a Washington State-chartered commercial bank, Sterling's subsidiary Sterling Savings Bank is subject to regulation and supervision by the FDIC and the Washington Department of Financial Institutions, or DFI. Federal and state laws and regulations govern numerous matters, including changes in the ownership or control of banks, maintenance of adequate capital and the financial condition of a financial institution, permissible types, amounts, and terms of extensions of credit and investments, maintenance of permissible non-banking activities, maintenance of deposit insurance, protection of financial privacy the level of reserves against deposits, and restrictions on dividend payments.

The FDIC, the Federal Reserve Board and the DFI possess cease and desist powers to prevent or remedy unsafe or unsound practices or violations of law by banks subject to their regulations. These and other restrictions limit the manner in which Sterling may conduct business and obtain capital or financing.

**Table of Contents****Sterling's stock price can be volatile.**

Sterling's stock price can fluctuate widely in response to a variety of factors, including actual or anticipated variations in quarterly operating results; changes in shareholder dividend policy; recommendations by securities analysts; and news reports relating to trends, concerns and other issues in the financial services industry. Other factors include new technology used or services offered by Sterling's competitors; operating and stock price performance of other companies that investors deem comparable to us; and changes in government regulations.

General market fluctuations, industry factors and general economic and political conditions and events, such as future terrorist attacks and activities, economic slowdowns or recessions, interest rate changes or credit loss trends, also could cause Sterling's stock price to decrease regardless of its operating results.

**Future legislation could change our competitive position.**

Various legislation, including proposals to change substantially the financial institution regulatory system and to expand or contract the powers of banking institutions and bank holding companies, is from time to time introduced in the Congress. This legislation may change banking statutes and Sterling's operating environment in substantial and unpredictable ways. If enacted, such legislation could increase or decrease the cost of doing business, limit or expand permissible activities or affect the competitive balance among banks, savings associations, credit unions, and other financial institutions. Sterling cannot predict whether any of this potential legislation will be enacted, and if enacted, the effect that it, or any implementing regulations, would have on Sterling's financial condition or results of operations.

**Item 1B. Unresolved Staff Comments**

Not applicable.

**Item 2. Properties**

At December 31, 2005, the net book value of Sterling's property (including land and buildings) and its furniture, fixtures and equipment was \$82.4 million. Sterling's corporate headquarters is in Spokane, Washington. A summary of Sterling's properties by state as of December 31, 2005 is as follows:

|            | Action | INTERVEST | Sterling<br>Savings<br>Bank | Sterling<br>Savings<br>Bank | Total | Total<br>Square<br>Footage |
|------------|--------|-----------|-----------------------------|-----------------------------|-------|----------------------------|
|            | Leased | Leased    | Leased                      | Owned                       |       |                            |
| Washington | 9      | 2         | 33                          | 45                          | 89    | 582,119                    |
| Oregon     | 9      | 1         | 31                          | 42                          | 83    | 275,328                    |
| Idaho      | 1      | 0         | 4                           | 8                           | 13    | 66,606                     |
| Montana    | 1      | 0         | 2                           | 7                           | 10    | 44,148                     |
| Arizona    | 0      | 1         | 0                           | 0                           | 1     | 1,940                      |
| California | 0      | 1         | 0                           | 0                           | 1     | 2,391                      |
| Utah       | 1      | 0         | 0                           | 0                           | 1     | 4,700                      |
| Total      | 21     | 5         | 70                          | 102                         | 198   | 977,232                    |

Leases on these properties expire between 2006 and 2044. Sterling believes it will be able to renew the leases as appropriate or obtain comparable properties.

**Item 3. Legal Proceedings**

Periodically, various claims are brought in connection with Sterling's business. No material loss is expected from any of such pending claims or lawsuits, although there can be no assurance in this regard.

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

Not applicable.

**Table of Contents****PART II****Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities****Stock Market and Dividend Information**

Sterling has outstanding one class of common stock. As of January 31, 2006, there were 34,889,044 shares of Sterling's common stock outstanding. As of January 31, 2006, Sterling's common stock was held by 1,922 shareholders of record, and the closing price as of that date for its common stock was \$28.02. Sterling's common stock is listed on The NASDAQ National Market under the symbol STSA.

The following table sets forth the high and low bid prices per share for Sterling's common stock for the periods indicated. Prior period amounts have been restated to reflect the 3 for 2 stock split that was effected on August 31, 2005:

|                               | <b>High</b> | <b>Low</b> |
|-------------------------------|-------------|------------|
| Year ended December 31, 2005: |             |            |
| Fourth quarter                | \$26.78     | \$21.86    |
| Third quarter                 | 27.39       | 21.66      |
| Second quarter                | 25.12       | 21.69      |
| First quarter                 | 26.75       | 23.36      |
| Year ended December 31, 2004: |             |            |
| Fourth quarter                | \$27.50     | \$23.26    |
| Third quarter                 | 23.87       | 20.45      |
| Second quarter                | 22.57       | 19.05      |
| First quarter                 | 23.61       | 20.12      |

On July 26, 2005, Sterling announced a quarterly cash dividend of \$0.05 per share of common stock, which resulted in a payment of \$1.7 million on October 14, 2005 to shareholders of record as of September 30, 2005. On October 25, 2005, Sterling announced a quarterly cash dividend of \$0.055 per share of common stock, which resulted in a payment of \$1.9 million on January 13, 2006 to shareholders of record as of December 30, 2005. On February 28, 2006, Sterling announced a quarterly cash dividend of \$0.06 per share of common stock, payable on April 13, 2006 to shareholders of record as of March 31, 2006. 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 requirements, capital requirements, the financial condition of Sterling and its subsidiaries, applicable government regulations and other factors deemed relevant by Sterling's board of directors.

**Table of Contents****Item 6. Selected Financial Data**

|   | <b>Years Ended December 31,</b>                         |             |             |             |             |
|---|---|-------------|-------------|-------------|-------------|
|   | <b>2005</b>   | <b>2004</b> | <b>2003</b> | <b>2002</b> | <b>2001</b> |
|   | <b>(Dollars in thousands, except per share amounts)</b> |             |             |             |             |
| Interest income                                       | \$ 387,811  | \$ 319,761  | \$ 214,727  | \$ 197,313  | \$ 201,385  |
| Interest expense                                      | (171,276)   | (122,945)   | (89,807)    | (96,965)    | (116,516)   |
| Net interest income                                   | 216,535   | 196,816     | 124,920     | 100,348     | 84,869      |
| Provision for losses on loans                         | (15,200)  | (12,150)    | (10,500)    | (11,867)    | (8,000)     |
| Net interest income after provision for loss on loans | 201,335   | 184,666     | 114,420     | 88,481      | 76,869      |
| Non-interest income                                   | 59,569  | 47,799      | 33,735      | 29,080      | 21,021      |
| Merger and acquisition costs                          | 0   | (4,835)     | (792)       | 0           | (283)       |
| Amortization of goodwill and core deposit intangibles | (2,222)   | (2,222)     | (262)       | (644)       | (5,377)     |
| Goodwill litigation                                   | (179)   | (141)       | (600)       | (1,100)     | (890)       |
| Non-interest expenses                                 | (167,880)   | (141,172)   | (92,910)    | (79,199)    | (66,743)    |
| Income before income taxes                            | 90,623  | 84,095      | 53,591      | 36,618      | 24,597      |
| Income tax provision                                  | (29,404)  | (27,790)    | (18,678)    | (11,031)    | (8,409)     |
| Net income  | \$ 61,219   | \$ 56,305   | \$ 34,913   | \$ 25,587   | \$ 16,188   |
| Earnings per share:                                   |   |             |             |             |             |
| Basic <sup>(1)</sup>                                  | \$ 1.77   | \$ 1.66     | \$ 1.45     | \$ 1.19     | \$ 0.81     |
| Diluted <sup>(1)</sup>                                | \$ 1.75   | \$ 1.62     | \$ 1.42     | \$ 1.16     | \$ 0.79     |
| Weighted average shares outstanding:                  |   |             |             |             |             |
| Basic <sup>(1)</sup>                                  | 34,633,952  | 33,931,509  | 23,980,113  | 21,496,008  | 19,974,152  |
| Diluted <sup>(1)</sup>                                | 35,035,029  | 34,708,794  | 24,590,172  | 22,115,723  | 20,372,423  |
| Financial Ratios:                                     |   |             |             |             |             |
| Book value per share <sup>(1)</sup>                   | \$ 14.54  | \$ 13.65    | \$ 10.21    | \$ 9.38     | \$ 7.87     |
| Return on average assets                              | 0.87%   | 0.88%       | 0.88%       | 0.80%       | 0.58%       |
| Return on average shareholders equity                 | 12.4%   | 13.2%       | 14.4%       | 13.9%       | 10.5%       |
| Shareholders equity to total assets                   | 6.7%  | 6.8%        | 5.9%        | 5.8%        | 5.5%        |
| Operating efficiency                                  | 61.7%   | 60.7%       | 59.6%       | 62.5%       | 69.2%       |
| Net interest margin                                   | 3.28%   | 3.32%       | 3.35%       | 3.37%       | 3.27%       |
| Nonperforming assets to total assets                  | 0.11%   | 0.20%       | 0.50%       | 0.59%       | 0.82%       |

Statistical Data:

Number of:

Employees (full-time  
equivalents)

1,789

1,624

1,121

953

890

Full service branches

140

135

86

79

77

33

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**Table of Contents****Item 6. Selected Financial Data (continued)**

|  | Years Ended December 31,                         |           |           |           |           |
|--|--|-----------|-----------|-----------|-----------|
|  | 2005   | 2004      | 2003      | 2002      | 2001      |
|  | (Dollars in thousands, except per share amounts) |           |           |           |           |
| Reported net income  | \$ 61,219  | \$ 56,305 | \$ 34,913 | \$ 25,587 | \$ 16,188 |
| Add back: goodwill amortization<br>net of tax <sup>(2)</sup> | 0  | 0         | 0         | 0         | 2,538     |
| Total  | \$ 61,219  | \$ 56,305 | \$ 34,913 | \$ 25,587 | \$ 18,726 |
| Basic earnings per share:                                    |  |           |           |           |           |
| Reported net income  | \$ 1.77  | \$ 1.66   | \$ 1.45   | \$ 1.19   | \$ 0.81   |
| Goodwill amortization  | 0.00   | 0.00      | 0.00      | 0.00      | 0.13      |
| Adjusted net income  | \$ 1.77  | \$ 1.66   | \$ 1.45   | \$ 1.19   | \$ 0.94   |
| Diluted earnings per share:                                  |  |           |           |           |           |
| Reported net income  | \$ 1.75  | \$ 1.62   | \$ 1.42   | \$ 1.16   | \$ 0.79   |
| Goodwill amortization  | 0.00   | 0.00      | 0.00      | 0.00      | 0.13      |
| Adjusted net income  | \$ 1.75  | \$ 1.62   | \$ 1.42   | \$ 1.16   | \$ 0.92   |

|   | December 31,           |              |              |              |              |
|---|------------------------|--------------|--------------|--------------|--------------|
|   | 2005                   | 2004         | 2003         | 2002         | 2001         |
|   | (Dollars in thousands) |              |              |              |              |
| Balance Sheet Data:                                     |                        |              |              |              |              |
| Total assets  | \$ 7,558,928           | \$ 6,942,224 | \$ 4,279,321 | \$ 3,507,021 | \$ 3,038,593 |
| Loans receivable, net                                   | 4,885,916              | 4,251,877    | 2,906,426    | 2,390,422    | 2,109,479    |
| Mortgage-backed securities                              | 1,960,582              | 2,036,920    | 983,736      | 743,610      | 617,569      |
| Investments   | 167,957                | 167,665      | 89,448       | 86,558       | 76,479       |
| Deposits  | 4,806,301              | 3,863,296    | 2,455,076    | 2,014,096    | 1,853,536    |
| FHLB Seattle advances                                   | 1,443,462              | 1,635,933    | 1,026,031    | 874,515      | 633,054      |
| Reverse repurchase<br>agreements and funds<br>purchased | 611,676                | 780,012      | 363,137      | 249,769      | 218,549      |
| Other borrowings  | 110,688                | 131,822      | 137,998      | 127,682      | 127,500      |
| Shareholders' equity                                    | 506,685                | 469,844      | 250,348      | 203,656      | 165,690      |

Capital Ratios<sup>(3)</sup>:

|   |       |       |       |       |       |
|---|-------|-------|-------|-------|-------|
| Total capital to<br>risk-weighted assets  |       |       |       |       |       |
| Sterling                                  | 10.5% | N/A   | N/A   | N/A   | N/A   |
| Sterling Savings Bank                     | 10.2% | 10.7% | 10.9% | 11.0% | 11.7% |
| Tier I capital to<br>risk-weighted assets |       |       |       |       |       |



|                                  |      |      |      |       |       |
|----------------------------------|------|------|------|-------|-------|
| Sterling                         | 9.5% | N/A  | N/A  | N/A   | N/A   |
| Sterling Savings Bank            | 9.2% | 9.7% | 9.9% | 10.0% | 10.8% |
| Tier I capital to average assets |      |      |      |       |       |
| Sterling                         | 7.4% | N/A  | N/A  | N/A   | N/A   |
| Sterling Savings Bank            | 7.2% | 6.6% | 7.4% | 7.6%  | 8.0%  |

(1) All prior period per share and weighted average share amounts have been restated to reflect the 3 for 2 stock split that was effected August 31, 2005.

(2) Sterling adopted SFAS No. 142 Goodwill and Intangible Assets on January 1, 2002. The tabular presentation reflects retroactive application of SFAS No. 142, even though SFAS No. 142 by its terms applies prospectively.

(3) Sterling Financial Corporation did not have regulatory capital ratio requirements prior to its conversion to a bank holding company.

**Table of Contents**

**Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations**

*The following discussion and analysis should be read in conjunction with the Consolidated Financial Statements and Notes thereto presented elsewhere in this report. This report contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. For a discussion of the risks and uncertainties inherent in such statements, see Business Forward-Looking Statements.*

**Executive Summary and Highlights**

During 2005, Sterling achieved significant loan, deposit and earnings growth. The loan portfolio grew by over \$630 million, or 14.9%, while deposits grew by over \$940 million, or 24.4%, over 2004. Loan production totaled \$3.88 billion for the year, leading to annual net income and earnings per diluted share growth of 8.7% and 8.0%, respectively, over 2004. At the same time, Sterling maintained disciplined underwriting standards that along with the improving economy, contributed to the improvement in asset quality.

Mortgage banking operations income increased to \$17.9 million for the year ended December 31, 2005, up from \$6.2 million for the same period in 2004. Sterling sold \$708.7 million in residential and commercial real estate loans during the year ended December 31, 2005, compared to \$202.4 million during the year ended December 31, 2004. The majority of these loan sales occurred during the second quarter of the year as Sterling capitalized on strong institutional demand for real estate loans and continued repositioning its loan portfolio to be more like that of a community bank.

Non-interest expenses increased 14.8% over 2004, primarily resulting from the addition of 165 full time equivalent employees during 2005.

**2005 Highlights**

Record net income of \$61.2 million.

Total assets increased 9% to a record \$7.56 billion.

Total deposits increased 24% to a record \$4.81 billion.

The number of transaction accounts grew 4% during 2005 to nearly 154,000.

Transaction deposits increased 12% over 2004.

Total loan originations were a record \$3.88 billion, up by 33% over 2004.

Non-interest income increased 25%.

Year-end nonperforming assets ratio of 0.11% of total assets was the lowest in Sterling's history.

Sterling completed the conversion of its charter from a thrift to a commercial bank holding company in July of 2005.

Effected a three-for-two stock split in August 2005.

Paid Sterling's first cash dividend on its common stock.

Expanded Sterling Savings Bank with ten new financial service centers, including retail branches, business banking teams, private banking teams and a corporate banking team.

**Critical Accounting Policies**

The accounting and reporting policies of Sterling conform to GAAP and to general practices within the banking industry. The preparation of the financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes.

Actual results

35

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**Table of Contents**

could differ from those estimates. Sterling's management has identified the accounting policies described below as those that, due to the judgments, estimates and assumptions inherent in those policies are critical to an understanding of Sterling's Consolidated Financial Statements and MD&A.

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

While management uses available information to provide for loan losses, the ultimate collectibility of a substantial portion of the loan portfolio and the need for future additions to the allowance will be based on changes in economic conditions and other relevant factors. A slowdown in economic activity could adversely affect cash flows for both commercial and individual borrowers, as a result of which Sterling could experience increases in nonperforming assets, delinquencies and losses on loans. 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 December 31, 2005.

***Investments and MBS.*** Assets in the investment 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 of the underlying loans. 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 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 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

**Table of Contents**

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. There were no investment securities which management identified to be other-than-temporarily impaired for the year ended December 31, 2005, 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. See Note 1 of Notes to Consolidated Financial Statements.

**Goodwill and Other Intangible Assets.** Goodwill arising from business combinations represents the value attributable to unidentifiable intangible elements in the business acquired. Sterling's goodwill relates to value inherent in the banking business and the value is dependent upon Sterling's ability to provide quality, cost-effective services in a competitive market place. As such, goodwill value is supported ultimately by revenue that is driven by the volume of business transacted. A decline in earnings as a result of a lack of growth or the inability to deliver cost-effective services over sustained periods can lead to impairment of goodwill that could adversely impact earnings in future periods.

Under GAAP in effect through December 31, 2001, Sterling amortized goodwill on a straight-line basis over periods ranging from ten to fifteen years. Effective January 1, 2002, Sterling adopted SFAS No. 142 and SFAS No. 147 and was therefore no longer required to amortize previously recorded goodwill.

Sterling's management performed the required annual test of its goodwill and other intangible assets as of June 30, 2005, and concluded that the recorded value of goodwill was not impaired. There are many assumptions and estimates underlying the determination of impairment. Another estimate using different but still reasonable assumptions could produce a significantly different result. Additionally, future events could cause management to conclude that Sterling's goodwill is impaired, which would result in Sterling recording an impairment loss. Any resulting impairment loss could have a material adverse impact on Sterling's financial condition and results of operations. Other intangible assets consisting of core-deposit intangibles with definite lives are amortized over the estimated life of the acquired depositor relationships.

**Loan Purchases.** In accordance with the American Institute of Certified Public Accountants' Statement of Position (SOP) 03-3, Accounting for Certain Loans or Debt Securities Acquired in a Transfer, loans acquired at a discount, when the discount is in part attributable to credit quality, should not have interest accrued on them at the coupon rate, but at a rate that is discounted for the credit quality issues. Changes in the estimates of cash flows will require an adjustment to the accrual rate. Sterling considers this guidance when entering into applicable transactions. Sterling paid premiums for loan purchases entered into during the effective time of this SOP, with substandard loans being withdrawn from the pools.

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

An allowance for losses on real estate and other assets owned is designed to include amounts for estimated losses as a result of impairment in value of the real property after repossession. Sterling reviews its real estate owned for impairment in value whenever events or circumstances indicate that the carrying value of the property 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.

**Table of Contents**

***Income Taxes.*** Sterling estimates income taxes payable based on the amount it expects to owe various tax authorities. Taxes are discussed in more detail in Note 12 of Notes to Consolidated Financial Statements. 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's deferred tax assets and liabilities are also discussed in more detail in Note 12 of Notes to Consolidated Financial Statements. Sterling uses an estimate of future earnings to support its position that the benefit of its net deferred taxes will be realized. If future pre-tax income should prove nonexistent or less than the amount of temporary differences giving rise to the net deferred tax assets within the tax years to which they may be applied, the assets will not be realized and Sterling's net income will be reduced.

**Results of Operations for the Years Ended December 31, 2005 and 2004**

***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 years ended December 31, 2005 and 2004, NII was \$216.5 million and \$196.8 million, respectively, an increase of 10.0%. The increase in NII during 2005 compared to 2004 was mainly due to increases in average loan volumes.

During the years ended December 31, 2005 and 2004, net interest margin was 3.28% and 3.32%, respectively, and net interest spread was 3.23% and 3.29%, respectively. 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 decreases in net interest margin and net interest spread are primarily due to the cost of funds increasing more rapidly than the yield on earning assets.

**Table of Contents**

The following table sets forth, for the periods indicated, information with regard to Sterling's NII, net spread and net interest margin:

|                                    | Years Ended December 31, |                     |                     |                        |                     |                     |                        |                     |                     |
|------------------------------------|--------------------------|---------------------|---------------------|------------------------|---------------------|---------------------|------------------------|---------------------|---------------------|
|                                    | 2005                     |                     |                     | 2004                   |                     |                     | 2003                   |                     |                     |
|                                    | Average                  | Interest            | Average             | Average                | Interest            | Average             | Average                | Interest            | Average             |
|                                    | Balance <sup>(1)</sup>   | or                  | Yield               | Balance <sup>(1)</sup> | or                  | Yield               | Balance <sup>(1)</sup> | or                  | Yield               |
|                                    |                          | Paid <sup>(2)</sup> | or                  |                        | Paid <sup>(2)</sup> | or                  |                        | Paid <sup>(2)</sup> | or                  |
|                                    |                          | Cost <sup>(3)</sup> | Cost <sup>(3)</sup> |                        | Cost <sup>(3)</sup> | Cost <sup>(3)</sup> |                        | Cost <sup>(3)</sup> | Cost <sup>(3)</sup> |
|                                    | (Dollars in thousands)   |                     |                     |                        |                     |                     |                        |                     |                     |
| Interest-earning assets:           |                          |                     |                     |                        |                     |                     |                        |                     |                     |
| Loans                              | \$ 4,482,012             | \$ 296,306          | 6.61%               | \$ 3,852,247           | \$ 229,448          | 5.96%               | \$ 2,721,149           | \$ 169,411          | 6.23%               |
| Mortgage-backed securities         | 1,948,435                | 88,682              | 4.55                | 1,885,239              | 85,009              | 4.51                | 913,260                | 41,193              | 4.51                |
| Investments and cash equivalents   | 168,853                  | 2,823               | 1.67                | 190,934                | 5,304               | 2.78                | 96,783                 | 4,123               | 4.26                |
| Total interest-earning assets      | \$ 6,599,300             | \$ 387,811          | 5.88%               | \$ 5,928,420           | \$ 319,761          | 5.39%               | \$ 3,731,192           | \$ 214,727          | 5.75%               |
| Interest-bearing liabilities:      |                          |                     |                     |                        |                     |                     |                        |                     |                     |
| Time deposits                      | \$ 2,041,122             | \$ 68,378           | 3.35%               | \$ 1,608,599           | \$ 41,299           | 2.57%               | \$ 1,152,281           | \$ 29,262           | 2.54%               |
| Regular savings and MMDA           | 1,158,270                | 22,272              | 1.92                | 1,092,612              | 11,347              | 1.04                | 572,842                | 6,578               | 1.15                |
| Interest-bearing demand accounts   | 419,137                  | 1,340               | 0.32                | 399,963                | 837                 | 0.21                | 318,722                | 991                 | 0.31                |
| Total interest-bearing deposits    | 3,618,529                | 91,990              | 2.54                | 3,101,174              | 53,483              | 1.72                | 2,043,845              | 36,831              | 1.80                |
| FHLB Seattle advances              | 1,430,621                | 49,259              | 3.44                | 1,428,557              | 46,491              | 3.25                | 969,833                | 36,662              | 3.78                |
| All other borrowings               | 648,449                  | 21,514              | 3.32                | 612,998                | 14,340              | 2.34                | 244,699                | 8,660               | 3.54                |
| Trust Preferred Securities         | 108,697                  | 8,277               | 7.61                | 108,674                | 6,616               | 6.05                | 72,929                 | 5,464               | 7.49                |
| Term note payable                  | 5,167                    | 236                 | 4.57                | 21,250                 | 739                 | 3.48                | 24,250                 | 918                 | 3.79                |
| Floating Rate Notes Due 2006       | 0                        | 0                   | 0.00                | 28,750                 | 1,276               | 4.44                | 30,000                 | 1,272               | 4.24                |
| Total interest-bearing liabilities | 5,811,463                | \$ 171,276          | 2.65%               | 5,301,403              | \$ 122,945          | 2.10%               | 3,385,556              | \$ 89,807           | 2.45%               |



|  |            |         |            |         |            |         |
|--|------------|---------|------------|---------|------------|---------|
| Net interest spread  | \$ 216,535 | 3.23%   | \$ 196,816 | 3.29%   | \$ 124,920 | 3.30%   |
| Net interest margin  |            | 3.28%   |            | 3.32%   |            | 3.35%   |
| Ratio of average interest-earning assets to average interest-bearing liabilities |            | 113.56% |            | 111.83% |            | 110.21% |

(1) Average balances are computed on a monthly basis.

(2) Interest earned from MBS securities includes \$1.9 million, \$2.2 million and \$487,000 of tax exempt interest for 2005, 2004 and 2003, respectively.

(3) The yield information for the available-for-sale portfolio does not give effect to changes in fair value that are reflected as a component of shareholders equity.

**Table of Contents**

Changes in Sterling's NII are a function of changes in both the rates and volumes of interest-earning assets and interest-bearing liabilities. The following table presents the components of the changes in NII for the periods presented. For each category of interest-earning assets and interest-bearing liabilities, the following table provides information on changes attributable to:

changes in volume changes in volume multiplied by comparative period rate;

changes in rate changes in rate multiplied by comparative period volume; and

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

Interest-earning asset and interest-bearing liability balances used in the calculations represent annual average balances computed using the average of each month's daily average balance during the years indicated.

|                                  | December 31, 2005           |           |                 |           | December 31, 2004           |            |                 |           |
|----------------------------------|-----------------------------|-----------|-----------------|-----------|-----------------------------|------------|-----------------|-----------|
|                                  | Increase (Decrease) Due to: |           |                 |           | Increase (Decrease) Due to: |            |                 |           |
|                                  | Volume                      | Rate      | Rate/<br>Volume | Total     | Volume                      | Rate       | Rate/<br>Volume | Total     |
|                                  | (Dollars in thousands)      |           |                 |           |                             |            |                 |           |
| Interest income on:              |                             |           |                 |           |                             |            |                 |           |
| Loans                            | \$ 37,508                   | \$ 25,226 | \$ 4,124        | \$ 66,858 | \$ 70,419                   | \$ (7,334) | \$ (3,048)      | \$ 60,037 |
| Mortgage-backed securities       | 2,850                       | 797       | 26              | 3,673     | 43,842                      | (12)       | (14)            | 43,816    |
| Investment and cash equivalents  | (613)                       | (2,112)   | 244             | (2,481)   | 4,011                       | (1,434)    | (1,396)         | 1,181     |
| Total interest income            | 39,745                      | 23,911    | 4,394           | 68,050    | 118,272                     | (8,780)    | (4,458)         | 105,034   |
| Interest-bearing deposits:       |                             |           |                 |           |                             |            |                 |           |
| Time deposits                    | 11,105                      | 12,589    | 3,385           | 27,079    | 11,588                      | 322        | 127             | 12,037    |
| Regular savings and MMDA         | 682                         | 9,662     | 581             | 10,925    | 5,969                       | (629)      | (571)           | 4,769     |
| Interest-bearing demand accounts | 40                          | 442       | 21              | 503       | 253                         | (324)      | (83)            | (154)     |
| Total deposits                   | 11,827                      | 22,693    | 3,987           | 38,507    | 17,810                      | (631)      | (527)           | 16,652    |
| FHLB Seattle advances            | 67                          | 2,697     | 4               | 2,768     | 17,341                      | (5,100)    | (2,412)         | 9,829     |
| All other borrowings             | 830                         | 5,994     | 346             | 7,170     | 13,013                      | (2,928)    | (4,401)         | 5,684     |
| Trust Preferred Securities       | 1                           | 1,659     | 1               | 1,661     | 2,678                       | (1,024)    | (502)           | 1,152     |
| Term note payable                | (559)                       | 232       | (176)           | (503)     | (114)                       | (75)       | 10              | (179)     |
| Floating Rate Notes Due 2006     | (1,272)                     | (1,272)   | 1,272           | (1,272)   | (53)                        | 55         | (2)             | 0         |

|                        |           |            |            |           |           |         |          |           |
|------------------------|-----------|------------|------------|-----------|-----------|---------|----------|-----------|
| Total interest expense | 10,894    | 32,003     | 5,434      | 48,331    | 50,675    | (9,703) | (7,834)  | 33,138    |
| Net interest income    | \$ 28,851 | \$ (8,092) | \$ (1,040) | \$ 19,719 | \$ 67,597 | \$ 923  | \$ 3,376 | \$ 71,896 |

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

Sterling recorded provisions for losses on loans of \$15.2 million and \$12.2 million for the years ended December 31, 2005 and 2004, respectively. The current provision reflects the analysis and assessment of the relevant factors mentioned in the preceding paragraph. Management anticipates that its provisions for losses on loans will continue to increase, reflecting Sterling's strategic direction of originating more commercial real estate, construction, business banking and consumer loans, which have a somewhat higher loss profile than Sterling's historical mix of loans. The increase in net loan charge-offs for the year ended December 31, 2005 as compared to the year ended December 31, 2004 primarily reflects the charge-offs of two loans, both of which were previously classified.

**Table of Contents**

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

|   | <b>Years Ended December 31,</b> |               |
|---|---------------------------------|---------------|
|   | <b>2005</b>                     | <b>2004</b>   |
|   | <b>(Dollars in thousands)</b>   |               |
| Balance at January 1                            | \$ 49,362                       | \$ 35,605     |
| Allowance for loan losses acquired              | 0                               | 6,722         |
| Provision for losses on loans                   | 15,200                          | 12,150        |
| Amounts written off net of recoveries and other | (9,079)                         | (5,115)       |
| <br>Balance at December 31                      | <br>\$ 55,483                   | <br>\$ 49,362 |

At December 31, 2005, Sterling's total classified assets were 0.79% of total assets, compared with 0.98% of total assets at December 31, 2004. Nonperforming assets were 0.11% of total assets at December 31, 2005, compared with 0.20% of total assets at December 31, 2004. At December 31, 2005, Sterling's loan delinquency rate (60 days or more) as a percentage of total loans was 0.18%, compared with 0.32% at December 31, 2004. Improvements in the quality of the loan portfolio, the sale of certain nonperforming assets and a general improvement in the economy contributed to the decreases in classified and nonperforming assets. Fewer delinquent loans, as well as the increase in total assets, led to the decrease in the delinquency ratio. Asset quality has been stable over the periods presented.

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

|  | <b>Years Ended</b>            |               |
|--|-------------------------------|---------------|
|  | <b>December 31,</b>           |               |
|  | <b>2005</b>                   | <b>2004</b>   |
|  | <b>(Dollars in thousands)</b> |               |
| Fees and service charges                         | \$ 34,702                     | \$ 32,692     |
| Mortgage banking operations                      | 17,899                        | 6,155         |
| Loan servicing fees                              | 434                           | 561           |
| Net gains (losses) on sales of securities        | (57)                          | 4,571         |
| REO operations                                   | 477                           | (162)         |
| Bank-owned life insurance                        | 5,914                         | 4,340         |
| Gain (charge) related to early repayment of debt | 645                           | (238)         |
| Other non-interest expense                       | (445)                         | (120)         |
| <br>Total non-interest income                    | <br>\$ 59,569                 | <br>\$ 47,799 |

The increase in non-interest income was primarily due to an increase in income from mortgage banking operations. The increase resulted from Sterling selling \$708.8 million in residential and commercial real estate loans during the year ended December 31, 2005 compared to \$202.4 million of such sales during the year ended December 31, 2004. The increase in sales during 2005 reflected Sterling's repositioning of the loan portfolio to be more like that of a community bank by capitalizing on strong institutional demand for real estate loans. Loan sales during 2005 resulted in gains of \$10.2 million compared to gains during 2004 of \$2.7 million, with the difference being primarily due to increases in volume.

**Table of Contents**

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

|  | <b>As of and for the<br/>Years Ended<br/>December 31,</b> |             |
|--|---|-------------|
|  | <b>2005</b>   | <b>2004</b> |
|  | <b>(Dollars in millions)</b>                              |             |
| Originations of residential mortgage loans                             | \$ 461.4  | \$ 400.4    |
| Originations of commercial real estate loans                           | 218.4   | 241.8       |
| Sales of residential loans   | 583.2   | 186.1       |
| Sales of commercial real estate loans                                  | 125.5   | 16.3        |
| Principal balances of residential loans serviced for others            | 606.7   | 373.6       |
| Principal balances of commercial real estate loans serviced for others | 814.2   | 593.3       |

During the year ended December 31, 2005, Sterling sold investments and MBS that resulted in net loss of \$57,000, compared with net gains of \$4.6 million for the year ended December 31, 2004. The fluctuation in net gains on sales of investments and MBS mainly reflects Sterling's strategy to manage interest rate risk on its MBS portfolio.

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

|  | <b>Years Ended<br/>December 31,</b> |             | <b>%<br/>Change</b> |
|--|-------------------------------------|-------------|---------------------|
|  | <b>2005</b>                         | <b>2004</b> |                     |
|  | <b>(Dollars in thousands)</b>       |             |                     |
| Employee compensation and benefits       | \$ 93,367                           | \$ 77,617   | 20.3                |
| Occupancy and equipment                  | 26,411                              | 23,051      | 14.6                |
| Depreciation                             | 8,627                               | 7,321       | 17.8                |
| Amortization of core deposit intangibles | 2,222                               | 2,222       | 0.0                 |
| Advertising                              | 9,125                               | 6,976       | 30.8                |
| Data processing                          | 12,678                              | 10,596      | 19.6                |
| Insurance                                | 1,213                               | 1,155       | 5.0                 |
| Legal and accounting                     | 3,134                               | 3,075       | 1.9                 |
| Travel and entertainment                 | 4,522                               | 4,071       | 11.1                |
| Goodwill litigation costs                | 179                                 | 141         | 27.0                |
| Merger and acquisition costs             | 0                                   | 4,835       | (100.0)             |
| Other                                    | 8,803                               | 7,310       | 20.4                |
| Total                                    | \$ 170,281                          | \$ 148,370  | 14.8                |

The increases in non-interest expenses were primarily due to higher employee compensation and benefits expenses. Full-time equivalent employees increased year-over-year by 165 to 1,789 at December 31, 2005. Other increases in non-interest expense were primarily due to increases in occupancy and equipment, advertising, data processing and depreciation expenses, mainly as a result of overall company growth.

**Income Tax Provision.** Sterling recorded federal and state income tax provisions of \$29.4 million and \$27.8 million for the years ended December 31, 2005 and 2004, respectively. The effective tax rates for these periods were 32.4% and 33.0%. The decrease in the effective tax rates primarily reflects changes in permanent tax differences and an increase in non taxable BOLI income from December 2005 insurance proceeds of \$1.4 million.



**Table of Contents****Results of Operations for the Years Ended December 31, 2004 and 2003**

**Net Interest Income.** NII for the years ended December 31, 2004 and 2003 was \$196.8 million and \$124.9 million, respectively. The 58% increase in NII was primarily due to growth in loan and MBS volumes following the KFBI acquisition. During the year ended December 31, 2004, average loans increased by \$1.13 billion, an increase of 42% over 2003. The increase in NII was partially offset by the decision of the FHLB Seattle not to make a fourth quarter dividend payment in 2004. Sterling had expected the dividend from the FHLB Seattle to be approximately \$800,000. During the same periods, the net interest margins were 3.32% and 3.35%, respectively, and net interest spreads were 3.29% and 3.30%, respectively. The decreases in net interest margin and net interest spread were primarily due to the continued flattening of the yield curve during 2004, wherein the yield on interest bearing assets declined at a faster rate than the decline in the cost of funds.

**Provision for Losses on Loans.** Sterling recorded provisions for losses on loans of \$12.2 million and \$10.5 million for the years ended December 31, 2004 and 2003, respectively. The following table summarizes loan loss allowance activity for the periods indicated:

|   | <b>Years Ended<br/>December 31,</b> |                  |
|---|-------------------------------------|------------------|
|   | <b>2004</b>                         | <b>2003</b>      |
|   | <b>(Dollars in thousands)</b>       |                  |
| Balance at January 1                            | \$ 35,605                           | \$ 27,866        |
| Allowance for loan losses acquired              | 6,722                               | 870              |
| Provision for losses on loans                   | 12,150                              | 10,500           |
| Amounts written off net of recoveries and other | (5,115)                             | (3,631)          |
|   | <b>\$ 49,362</b>                    | <b>\$ 35,605</b> |

At December 31, 2004, Sterling's total classified assets were 0.98% of total assets, compared with 1.98% of total assets at December 31, 2003. Total nonperforming assets were 0.20% of total assets at December 31, 2004, compared with 0.50% of total assets at December 31, 2003. At December 31, 2004, Sterling's loan delinquency rate (60 days or more) as a percentage of total loans was 0.32%, compared with 0.90% at December 31, 2003. Improvements in the quality of the loan portfolio and the sale of certain nonperforming assets contributed to the decreases in classified and nonperforming assets. Fewer delinquent loans, as well as the increase in total assets, led to the decrease in the delinquency ratio.

**Table of Contents**

**Non-Interest Income.** The following table summarizes the components of non-interest income for the periods indicated:

|   | <b>Years Ended<br/>December 31,</b> |                  |
|---|-------------------------------------|------------------|
|   | <b>2004</b>                         | <b>2003</b>      |
|   | <b>(Dollars in thousands)</b>       |                  |
| Fees and service charges                  | \$ 32,692                           | \$ 19,168        |
| Mortgage banking operations               | 6,155                               | 8,482            |
| Loan servicing fees                       | 561                                 | 566              |
| Net gains on sales of securities          | 4,571                               | 3,694            |
| Real estate owned operations              | (162)                               | (73)             |
| Bank-owned life insurance                 | 4,340                               | 3,742            |
| Charge related to early repayment of debt | (238)                               | (1,464)          |
| Other non-interest expense                | (120)                               | (380)            |
| <b>Total non-interest income</b>          | <b>\$ 47,799</b>                    | <b>\$ 33,735</b> |

Fees and service charge income increased by 71% to \$32.7 million for the year ended December 31, 2004, from \$19.2 million for the same period last year. This increase was largely due to an increase in the number of transaction accounts, increased service fee rates and fees for new overdraft protection services. Sterling had 147,704 transaction accounts at December 31, 2004, an increase of 61,388 accounts for the year. Most of this increase was from transaction accounts acquired in the KFBI acquisition.

The decrease in income from mortgage banking operations for the year ended December 31, 2004, compared with the year ended December 31, 2003, was largely due to lower residential permanent loan originations and a lower volume of sales of residential loans into the secondary market. Overall, the margin on these loan sales for 2004 was 1.33%, compared with 1.50% for 2003.

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

|  | <b>Years Ended<br/>December 31,</b> |             |
|--|-------------------------------------|-------------|
|  | <b>2004</b>                         | <b>2003</b> |
|  | <b>(Dollars in millions)</b>        |             |
| Originations of residential mortgage loans                             | \$ 400.4                            | \$ 504.2    |
| Originations of commercial real estate loans                           | 241.8                               | 114.5       |
| Sales of residential loans   | 186.1                               | 360.5       |
| Sales of commercial real estate loans                                  | 16.3                                | 35.9        |
| Principal balances of residential loans serviced for others            | 373.6                               | 329.6       |
| Principal balances of commercial real estate loans serviced for others | 593.3                               | 211.5       |

During the year ended December 31, 2004, Sterling sold investments and MBS, resulting in net gains of \$4.6 million compared to net gains of \$3.7 million for the year ended December 31, 2003. The increase in net gains on sales of investments and MBS mainly reflects Sterling's strategy to manage interest rate risk on its MBS portfolio.



**Table of Contents**

**Non-Interest Expense.** Non-interest expenses were as follows for the years presented.

|  | <b>Years Ended<br/>December 31,</b> |                  | <b>%<br/>Change</b> |
|--|-------------------------------------|------------------|---------------------|
|  | <b>2004</b>                         | <b>2003</b>      |                     |
|  | <b>(Dollars in thousands)</b>       |                  |                     |
| Employee compensation and benefits       | \$ 77,617                           | \$ 51,066        | 52.0                |
| Occupancy and equipment                  | 23,051                              | 14,687           | 56.9                |
| Depreciation                             | 7,321                               | 4,994            | 46.6                |
| Amortization of core deposit intangibles | 2,222                               | 262              | 748.1               |
| Advertising                              | 6,976                               | 5,316            | 31.2                |
| Data processing                          | 10,596                              | 6,786            | 56.1                |
| Insurance                                | 1,155                               | 750              | 54.0                |
| Legal and accounting                     | 3,075                               | 2,206            | 39.4                |
| Travel and entertainment                 | 4,071                               | 2,711            | 50.2                |
| Goodwill litigation costs                | 141                                 | 600              | (76.5)              |
| Merger and acquisition costs             | 4,835                               | 792              | 510.5               |
| Other                                    | 7,310                               | 4,394            | 66.4                |
| <b>Total</b>                             | <b>\$ 148,370</b>                   | <b>\$ 94,564</b> | <b>56.9</b>         |

The higher level of non-interest expenses was due to increases in employee compensation and benefits, occupancy, data processing, merger and acquisition costs and other expenses, mainly as a result of increased volume following the KFBI acquisition. The number of full time equivalent employees increased by 503 during 2004. The KFBI acquisition added 48 branches, resulting in higher occupied space, staff equipment and data processing costs. The increase in other expenses reflected increased bank transaction and loan processing costs from the growth in deposit and loan account volumes following the KFBI acquisition, while the amount for 2003 was net of a refund of excise taxes.

**Income Tax Provision.** Sterling recorded federal and state income tax provisions of \$27.8 million and \$18.7 million for the years ended December 31, 2004 and 2003, respectively. The effective tax rates for these periods were 33.0% and 34.9%. The decrease in the effective tax rate was related to the effect of tax credits for investments in certain low-income housing developments.

**Financial Position**

**Assets.** At December 31, 2005, Sterling's assets were \$7.56 billion, up 8.9% from \$6.94 billion at December 31, 2004. This growth was driven mainly by increases in the loan portfolio, primarily through originations.

**Loans Receivable.** At December 31, 2005, net loans receivable were \$4.89 billion, up \$634.0 million from \$4.25 billion at December 31, 2004. The increase was primarily due to record loan originations of \$3.88 billion during the year.

**Investments and MBS.** Sterling's investment and MBS portfolio at December 31, 2005 was \$2.13 billion, a decrease of \$76.0 million from the December 31, 2004 balance of \$2.20 billion. The decrease was due to principal paydowns exceeding purchases. At December 31, 2005, the net unrealized holding loss on the investment and MBS portfolio was \$54.1 million versus \$14.8 million in 2004. Fluctuations in prevailing interest rates continue to cause volatility in this component of accumulated comprehensive income and may continue to do so in future periods.

**Bank-Owned Life Insurance ( BOLI ).** BOLI increased to \$107.6 million at December 31, 2005, from \$93.8 million at December 31, 2004. The increase was primarily due to the \$10.0 million of BOLI purchased in July 2005. Sterling uses the earnings from BOLI to fund employee benefit costs. Through BOLI, Sterling becomes the beneficiary of life insurance policies on certain officers who consent to the issuance of the policies.

**Table of Contents**

**Goodwill and Other Intangible Assets.** Goodwill and other intangible assets decreased to \$130.3 million at December 31, 2005, from \$132.2 million at December 31, 2004. See Note 7 of Notes to Consolidated Financial Statements.

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

|                              | December 31, 2005      |       | December 31, 2004 |       |
|------------------------------|------------------------|-------|-------------------|-------|
|                              | Amount                 | %     | Amount            | %     |
|                              | (Dollars in thousands) |       |                   |       |
| Interest-bearing checking    | \$ 432,936             | 9.0   | \$ 413,217        | 10.7  |
| Noninterest-bearing checking | 673,934                | 14.0  | 574,186           | 14.9  |
| Savings (and MMDA)           | 1,312,033              | 27.3  | 1,104,871         | 28.6  |
| Time deposits                | 2,387,398              | 49.7  | 1,771,022         | 45.8  |
| Total deposits               | \$ 4,806,301           | 100.0 | \$ 3,863,296      | 100.0 |
| Annualized cost of deposits  |                        | 2.16% |                   | 1.47% |

The growth in time deposits reflects Sterling's use of brokered CD's as a cost competitive source of funding asset growth. Savings and transaction account deposit growth reflects Sterling's offering of a larger selection of products and services, and emphasis on business and corporate banking relationships.

**Borrowings.** Deposit accounts are Sterling's primary source of funds. Sterling does, however, rely upon advances from the FHLB Seattle, reverse repurchase agreements and other borrowings to fund asset growth and to meet deposit withdrawal requirements. At December 31, 2005, the total of such borrowings was \$2.17 billion compared with \$2.55 billion at December 31, 2004. During the first quarter of 2005, Sterling prepaid \$258.0 million of FHLB Seattle advances, resulting in a net gain on the extinguishment of debt of \$645,000. Other borrowings decreased from December 31, 2004, as Sterling paid off its term note to U.S. Bank. See Liquidity and Capital Resources.

**Table of Contents****Asset and Liability Management**

The results of operations for financial institutions may be materially and adversely affected by changes in prevailing economic conditions, including rapid changes in interest rates, declines in real estate market values and the monetary and fiscal policies of the federal government. Like all financial institutions, Sterling's NII and the net present value of assets, liabilities and off-balance sheet contracts ( NPV ), or estimated fair value, are subject to fluctuations in interest rates. For example, some of Sterling's ARMs are indexed to various U.S. Treasury indices or periodic fixed-rate LIBOR and swaps curves. When interest-earning assets such as loans are funded by interest-bearing liabilities such as deposits, FHLB Seattle advances and other borrowings, a changing interest rate environment may have a dramatic effect on Sterling's earnings. Currently, Sterling's interest-bearing liabilities, consisting primarily of savings and time deposits, FHLB Seattle advances and other borrowings, mature or reprice more frequently, or on different terms, than do its interest-earning assets. The fact that liabilities mature or reprice more frequently on average than assets may be beneficial in times of decreasing interest rates; however, such an asset/liability structure may result in declining NII during periods of rising interest rates.

Additionally, the extent to which borrowers prepay loans is affected by prevailing interest rates. When interest rates increase, borrowers are less likely to prepay loans; whereas, when interest rates decrease, borrowers are more likely to prepay loans. Prepayments may affect the levels of loans retained in an institution's portfolio, as well as its NII. Sterling maintains an asset and liability management program intended to manage NII through interest rate cycles and to protect its NPV by controlling its exposure to changing interest rates. Sterling uses a simulation model designed to measure the sensitivity of NII and NPV to changes in interest rates. This simulation model is designed to enable Sterling to generate a forecast of NII and NPV given various interest rate forecasts and alternative strategies. The model is also designed to measure the anticipated impact that prepayment risk, basis risk, customer maturity preferences, volumes of new business and changes in the relationship between long-term and short-term interest rates have on the performance of Sterling. The model calculates the present value of assets, liabilities, off-balance sheet financial instruments and equity at current interest rates and at hypothetical higher and lower interest rates at various intervals. The present value of each major category of financial instruments is calculated using estimated cash flows based on weighted-average contractual rates and terms, then discounted at the estimated current market interest rate for similar financial instruments. The present value of longer term fixed-rate financial instruments is more difficult to estimate because such instruments are susceptible to changes in market interest rates. Present value estimates of adjustable-rate financial instruments are more reliable since they represent the difference between the contractual and discounted rates until the next interest rate repricing date, combined with adjustments for the impact of rate caps and floors.

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

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

Sterling is continuing to pursue strategies to manage the level of its IRR while increasing its NII and NPV: a) through the origination and retention of variable-rate consumer, business banking, construction and commercial real estate loans, which generally have higher yields than residential permanent loans; b) by the sale of certain long-term fixed-rate loans and investments; and c) by increasing the level of its core deposits, which are generally a lower-cost

funding source than wholesale borrowings. There can be no assurance that Sterling will be successful implementing any of these strategies or that, if these strategies are implemented, they will have the intended effect of reducing IRR or increasing NII.

**Table of Contents**

The following table indicates the projected sensitivity of Sterling's NII one year forward from the balance sheet dates indicated. The results reflect the potential effect of instantaneous, parallel shifts in the market yield curve on a static balance sheet with a flat interest rate forecast. These calculations are highly subjective and technical and are relative measurements of IRR, which do not necessarily reflect any expected rate movement.

|        | <b>Change in Interest<br/>Rate in Basis Points<br/>(Rate Shock)</b> | <b>December 31,</b>            |                            |
|--------|---|--------------------------------|----------------------------|
|        |   | <b>2005</b>                    | <b>2004</b>                |
|        |   | <b>%<br/>Change in<br/>NII</b> | <b>% Change<br/>in NII</b> |
| +300   |   | (7.3)                          | 1.1                        |
| +200   |   | (4.6)                          | 1.4                        |
| +100   |   | (2.4)                          | 0.0                        |
| Static |   | 0.0                            | 0.0                        |
| -100   |   | (0.5)                          | 0.3                        |
| -200   |   | (5.2)                          | (4.8)                      |
| -300   |   | (7.0)                          | N/A <sup>(1)</sup>         |

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

| <b>Change in<br/>Interest Rate<br/>in Basis Points<br/>(Rate Shock)<br/>(Dollars in thousands)</b> | <b>At December 31, 2005</b> |  |                                | <b>At December 31, 2004</b> |  |                                |
|--|-----------------------------|--|--------------------------------|-----------------------------|--|--------------------------------|
|  | <b>NPV</b>                  | <b>Ratio of<br/>NPV<br/>to the<br/>Present<br/>Value of<br/>Total<br/>Assets</b> | <b>%<br/>Change<br/>in NPV</b> | <b>NPV</b>                  | <b>Ratio of<br/>NPV<br/>to the<br/>Present<br/>Value of<br/>Total<br/>Assets</b> | <b>%<br/>Change<br/>in NPV</b> |
| +300   | \$697,159                   | 9.16%  | (13.5)                         | \$450,691                   | 6.62%  | (22.0)                         |
| +200   | 748,211                     | 9.74   | (7.1)                          | 507,295                     | 7.35   | (12.2)                         |
| +100   | 777,474                     | 10.04  | (3.5)                          | 553,335                     | 7.91   | (4.3)                          |
| Static   | 805,739                     | 10.32  | 0.0                            | 577,971                     | 8.17   | 0.0                            |
| -100   | 758,300                     | 9.71   | (5.9)                          | 527,953                     | 7.45   | (8.7)                          |
| -200   | 600,547                     | 7.79   | (25.5)                         | 369,634                     | 5.28   | (36.1)                         |
| -300   | 407,394                     | 5.37   | (49.4)                         | N/A <sup>(1)</sup>          | N/A <sup>(1)</sup>   | N/A <sup>(1)</sup>             |

(1) Projections assuming large interest rate decreases in low interest rate environments are not included because they would not result in a meaningful

calculation.

Sterling does not manage its IRR by means of gap analysis. Instead, Sterling uses simulation modeling, which provides a more complete analysis than gap analysis, because gap analysis is a more simple analytical tool designed only to measure the difference between the amount of interest-earning assets and the amount of interest-bearing liabilities expected to mature or reprice in a given period. Gap analysis indicates theoretical repricing mismatches, but it does not consider basis differences that simulation modeling attempts to measure, such as differences due to yield curve shape, prepayment variability and other optionality. Gap analysis also does not consider liabilities that have embedded options, a feature that allows liabilities to be called from the holders prior to contractual maturity.

Cumulative gap positions are provided herein to indicate the general direction of the interest rate sensitivity of Sterling's assets and liabilities at the balance sheet dates indicated. A positive position indicates that assets maturing or repricing in a given period exceed maturing or repricing liabilities. A negative position indicates the opposite. An indication of a pricing match or mismatch does not necessarily indicate that income will change by any amount as the assets and liabilities may reprice to different indices, market rates for new products may vary and management may change discretionary pricing.

**Table of Contents**

Sterling calculated its one-year cumulative gap position to be a negative 10.4% and a negative 13.0% at December 31, 2005 and 2004, respectively. Sterling calculated its three-year gap position to be a negative 0.6% and a negative 9.4% at December 31, 2005 and 2004, respectively. While the one-year cumulative gap shows liability sensitivity at December 31, 2005, it does not correlate directly to an increased exposure to rising interest rates. During the first quarter of 2005, Sterling restructured certain higher-rate borrowings with extensions, and certain borrowings which had premiums assigned when they were acquired. Additionally, loan prepayment speeds for long-term loans can vary substantially in a rising rate environment. These effects are not considered when calculating traditional gap analysis. As a result of these restructuring and certain loan sales during the year ended December 31, 2005, management believes that it has improved Sterling's IRR profile and will be able to better manage IRR. Management attempts to maintain Sterling's gap position between positive 10% and negative 25%. At December 31, 2005 and 2004, Sterling's gap positions were within limits established by its Board of Directors. Management is pursuing strategies to increase its NII without significantly increasing its cumulative gap positions in future periods. There can be no assurance that Sterling will be successful implementing these strategies or that, if these strategies are implemented, they will have the intended effect of increasing its NII. See Results of Operations *Net Interest Income* and Capital.

**Table of Contents**

The following table sets forth the estimated maturity/repricing and the resulting gap between Sterling's interest-earning assets and interest-bearing liabilities at December 31, 2005. Other than loans, which are in the held-for-sale portfolio, all of the financial instruments of Sterling are intended to be held for indefinite periods of time. The estimated maturity/repricing amounts reflect contractual maturities and amortizations, assumed loan prepayments based upon Sterling's historical experience, estimates from secondary market sources such as FHLMC and estimated regular savings deposit decay rates (the rate of withdrawals or transfers to higher-yielding CDs). Management believes these assumptions and estimates are reasonable, but there can be no assurance in this regard. The classification of mortgage loans, investments and MBS is based upon regulatory reporting formats and, therefore, may not be consistent with the financial information contained elsewhere in this Report on Form 10-K.

|   | <b>0 to 3<br/>Months</b> | <b>Over<br/>3 Months<br/>to 1 Year</b> | <b>Maturity or Repricing<br/>Over<br/>1 Year<br/>to 3 Years<br/>(Dollars in thousands)</b> | <b>Over<br/>3 Years<br/>to 5<br/>Years</b> | <b>Over<br/>5 Years</b> | <b>Total</b>        |
|---|--------------------------|--|--|--|-------------------------|---------------------|
| <b>Interest-earning assets:</b>           |                          |  |  |  |                         |                     |
| <b>Mortgage loans and MBS:</b>            |                          |  |  |  |                         |                     |
| ARM, balloon mortgage loans and MBS       | \$ 1,358,812             | \$ 296,003                             | \$ 392,073   | \$ 196,051                                 | \$ 39,205               | \$ 2,282,144        |
| Fixed-rate mortgage loans and MBS         | 97,852                   | 299,080                                | 664,553  | 485,985                                    | 819,394                 | 2,366,864           |
| Loans held for sale                       | 7,894                    | 0                                      | 0  | 0  | 0                       | 7,894               |
| <b>Total mortgage loans and MBS</b>       | <b>1,464,558</b>         | <b>595,083</b>                         | <b>1,056,626</b>   | <b>682,036</b>                             | <b>858,599</b>          | <b>4,656,902</b>    |
| <b>Commercial and consumer loans:</b>     |                          |  |  |  |                         |                     |
| Consumer                                  | 242,496                  | 108,236                                | 227,102  | 114,213                                    | 89,848                  | 781,895             |
| Commercial                                | 819,821                  | 228,612                                | 282,861  | 159,582                                    | 34,992                  | 1,525,868           |
| <b>Total loans and MBS</b>                | <b>2,526,875</b>         | <b>931,931</b>                         | <b>1,566,589</b>   | <b>955,831</b>                             | <b>983,439</b>          | <b>6,964,665</b>    |
| Cash and investments                      | 95,287                   | 8,319                                  | 15,792   | 1,032                                      | 47,741                  | 168,171             |
|   | 2,622,162                | 940,250                                | 1,582,381  | 956,863                                    | 1,031,180               | 7,132,836           |
| Cash on hand and in banks                 | 0                        | 0                                      | 0  | 0  | 132,169                 | 132,169             |
| Other noninterest-earning assets          | 0                        | 0                                      | 0  | 0  | 293,923                 | 293,923             |
| <b>Total assets</b>                       | <b>\$ 2,622,162</b>      | <b>\$ 940,250</b>                      | <b>\$ 1,582,381</b>  | <b>\$ 956,863</b>                          | <b>\$ 1,457,272</b>     | <b>\$ 7,558,928</b> |
| <b>Interest-bearing liabilities:</b>      |                          |  |  |  |                         |                     |
| <b>Deposits:</b>                          |                          |  |  |  |                         |                     |
| Time deposits                             | \$ 719,251               | \$ 1,128,546                           | \$ 305,694   | \$ 136,863                                 | \$ 97,044               | \$ 2,387,398        |
| Checking accounts                         | 40,308                   | 83,661                                 | 69,989   | 61,440                                     | 851,472                 | 1,106,870           |
| MMDA                                      | 248,011                  | 498,931                                | 63,748   | 48,244                                     | 265,453                 | 1,124,387           |
| Passbook accounts                         | 20,038                   | 40,077                                 | 0  | 0  | 127,531                 | 187,646             |
| <b>Total deposits</b>                     | <b>1,027,608</b>         | <b>1,751,215</b>                       | <b>439,431</b>   | <b>246,547</b>                             | <b>1,341,500</b>        | <b>4,806,301</b>    |
| FHLB Seattle advances                     | 805,329                  | 192,711                                | 301,654  | 90,000                                     | 53,768                  | 1,443,462           |
| Repurchase agreements and funds purchased | 363,870                  | 97,806                                 | 100,000  | 0  | 50,000                  | 611,676             |
| Other borrowings                          | 83,964                   | 24,743                                 | 0  | 0  | 0                       | 108,707             |



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|  |              |                |             |            |              |              |
|--|--------------|----------------|-------------|------------|--------------|--------------|
| Total interest-bearing liabilities         | \$ 2,280,771 | \$ 2,066,475   | \$ 841,085  | \$ 336,547 | \$ 1,445,268 | \$ 6,970,146 |
| Other noninterest-bearing liabilities      | 0            | 0              | 0           | 0          | 82,097       | 82,097       |
| Shareholders' equity                       | 0            | 0              | 0           | 0          | 506,685      | 506,685      |
| Total liabilities and shareholders' equity | \$ 2,280,771 | \$ 2,066,475   | \$ 841,085  | \$ 336,547 | \$ 2,034,050 | \$ 7,558,928 |
| Net gap                                    | \$ 341,391   | \$ (1,126,225) | \$ 741,296  | \$ 620,316 | \$ (576,778) | \$ 0         |
| Cumulative gap                             | \$ 341,391   | \$ (784,834)   | \$ (43,538) | \$ 576,778 | \$ 0         | \$ 0         |
| Cumulative gap to total assets             | 4.52%        | (10.38%)       | (0.58%)     | 7.63%      | 0.00%        | 0.00%        |

50

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

As a financial institution, Sterling's primary sources of funds are investing and financing activities, including collecting loan principal and interest payments. Financing activities consist primarily of customer deposits, advances from FHLB Seattle and other borrowings. Deposits increased 24.4% to \$4.81 billion at December 31, 2005 from \$3.86 billion at December 31, 2004, mainly due to increases of \$616.4 million in time deposits. The increase in time deposits primarily reflects Sterling's use of brokered CD's as a cost competitive source of funding asset growth. 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 year ended December 31, 2005, net cash used in investing activities was \$629.8 million, which consisted mainly of loans funded, loans purchased and MBS purchases totaling \$4.20 billion, partially offset by cash inflows totaling \$3.59 billion from principal paydowns and proceeds from sales of portions of the loan and MBS portfolios. During the year, net cash provided by financing activities was \$565.6 million, which consisted primarily of net inflows from deposit accounts, partially offset by net repayments on FHLB and reverse repurchase agreement wholesale funds totaling \$359.1 million.

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 December 31, 2005, this credit line represented a total borrowing capacity of \$2.36 billion, of which \$278.8 million was available. On April 5, 2005, the FHLB Seattle announced the submission of a proposed three-year business and capital management plan to its regulator. The three-year plan expands member access to advances by allowing members to support new advances with their outstanding membership stock, as well as their outstanding activity based stock. However, the FHLB Seattle indicated that over the next few years, while it implements its new business plan, minimal to no dividends would be available to its members. Based on this guidance, Sterling anticipates a decrease in dividend income of approximately \$2.0 million per year.

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 December 31, 2005, Sterling Savings Bank had \$611.7 million in outstanding borrowings under reverse repurchase agreements and had securities available for additional secured borrowings of approximately \$277.2 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. For additional information regarding reverse repurchase agreements, see Asset and Liability Management and Note 10 of Notes to Consolidated Financial Statements.

Sterling, on a parent company-only basis, had cash of approximately \$15.7 million and \$19.2 million at December 31, 2005 and December 31, 2004, respectively. At December 31, 2005 and 2004, Sterling had an investment of \$110.1 million in the preferred stock of Sterling Savings Bank. At December 31, 2005 and 2004, Sterling had an investment in the common stock of Sterling Savings Bank of \$294.6 million. Sterling received cash dividends on Sterling Savings Bank preferred stock of \$11.6 million during the year ended December 31, 2005. These resources contributed to Sterling's ability to meet its operating needs, including interest expense on its long-term debt. Sterling Savings Bank's ability to pay dividends is limited by its earnings, financial condition and capital requirements, as well as regulatory restrictions. See Note 24 of Notes to Consolidated Financial Statements.



assuming all  
current  
participants  
become fully  
vested in their  
respective plans  
or  
arrangements.  
See Note 18 of  
Notes to  
Consolidated  
Financial  
Statements.

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 material effect in the future. See Note 17 of Notes to Consolidated Financial Statements.

Sterling, through its subsidiary Action Mortgage, enters into rate lock commitments to prospective residential mortgage borrowers. Action Mortgage hedges IRR by entering into best efforts forward sales agreements with third parties. In addition, to improve and protect the profit margin on loans sold into the secondary market, Action Mortgage hedges IRR by entering into mandatory forward sales agreements on MBS with third parties.

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

Rate lock commitments and forward sales agreements are considered to be derivatives. Sterling has recorded the estimated fair values of the rate lock commitments and forward sales agreements on its balance sheet in either other assets or other liabilities. Changes in the fair values of these derivative instruments are recorded in income from mortgage banking operations in the income statement as the changes occur. The estimated fair value of rate lock commitments and forward sales agreements as compared to the contracted amounts at December 31, 2005 resulted in an asset of \$147,000 and a liability of \$25,000, respectively. At December 31, 2004, rate lock commitments and forward sales agreements were assets of \$76,000 and \$12,000, respectively.

**Table of Contents**

**Capital**

Sterling's total shareholders' equity was \$506.7 million at December 31, 2005, compared with \$469.8 million at December 31, 2004. The increase in total shareholders' equity was primarily due to the retention of earnings, partially offset by an increase in the unrealized loss on the investment portfolio. Shareholders' equity was 6.7% of total assets at December 31, 2005, compared with 6.8% at December 31, 2004.

At December 31, 2005, Sterling had an unrealized loss of \$54.1 million on investments and MBS classified as available for sale. At December 31, 2004, Sterling had an unrealized loss of \$14.8 million on investments and MBS classified as available for sale. The change since December 31, 2004 reflects the decrease in the market value of the MBS portfolio, which was primarily caused by the increase in long-term interest rates compared to those at December 31, 2004. 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 qualify as Tier 1 capital, subject to certain limitations. For a complete description, see Note 11 of Notes to Consolidated Financial Statements.

In December 2005, Sterling registered one million shares of its common stock. These shares will periodically be issued pursuant to Sterling's Dividend Reinvestment and Direct Stock Purchase and Sale Plan.

Sterling and Sterling Savings Bank are required by applicable regulations to maintain certain minimum capital levels. Sterling and Sterling Savings Bank intend to enhance their capital resources and regulatory capital ratios through the retention of an adequate amount of earnings and management of the level and mix of assets, although there can be no assurance that they will be successful in this regard. At December 31, 2005, Sterling and Sterling Savings Bank both exceeded all such regulatory capital requirements and were well-capitalized pursuant to such regulations.

**Goodwill Litigation**

In May 1990, Sterling sued the U.S. Government with respect to the loss of the goodwill treatment and other matters relating to Sterling's past acquisitions of three troubled thrift institutions during the 1980s (the Goodwill Litigation ), seeking damages for, among other things, breach of contract. In September 2002, the U.S. Court of Federal Claims granted Sterling's motion for summary judgment as to liability on its contract claim, holding that the U.S. Government owed contractual obligations to Sterling 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. Sterling opposed the motion. Sterling is waiting for a decision on the motion and for a trial date to be set to determine what amount, if any, the government must pay in damages for its breach. The timing and ultimate outcome of the Goodwill Litigation cannot be predicted with certainty.

**Table of Contents**

**New Accounting Policies**

In December 2004, the FASB issued SFAS No. 123 (revised 2004), Share-Based Payment, which established accounting standards for transactions involving the issuance of equity instruments to employees for services rendered. This statement is a revision of SFAS No. 123, and supersedes APB No. 25. This statement requires the estimation and recognition of the grant date fair value of stock options issued to employees. This statement is effective for Sterling as of January 1, 2006. Management has evaluated the effect of this new standard, and has determined that the cost of currently outstanding unvested stock options will not have a material effect on Sterling's consolidated financial statements. Management is currently evaluating what form, if any, of share based compensation it will implement in the future.

In November 2005, FASB Staff Position ( FSP ) No. 115-1 The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments, was released. This FSP addresses when an investment is considered impaired, whether that impairment is other than temporary, and the measurement of an impairment loss. This FSP requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. This FSP is effective for reporting periods beginning after December 15, 2005, with early application permitted. Sterling has applied this standard, and it did not have a material effect on the consolidated financial statements.

**Effects of Inflation and Changing Prices**

A savings institution has an asset and liability structure that is interest-rate sensitive. As a holder of monetary assets and liabilities, a financial institution's performance may be significantly influenced by changes in interest rates. Although changes in the prices of goods and services do not necessarily move in the same direction as interest rates, increases in inflation generally have resulted in increased interest rates, which may have an adverse effect on Sterling's business.

**Item 7A. Quantitative and Qualitative Disclosures About Market Risk**

For a discussion of Sterling's market risk, see MD&A Asset and Liability Management.

**Item 8. Financial Statements and Supplementary Data**

The required information is contained on pages F-1 through F-45 of this Form 10-K.

**Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure**

There were no disagreements with Sterling's independent accountants on accounting and financial disclosures.

**Table of Contents**

**Item 9A. 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.

**Management's Report on Internal Control Over Financial Reporting**

Sterling's management, including the principal executive officer and principal financial officer, is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rule 13a-15(f). Under the supervision and with the participation of Sterling's management, Sterling conducted an evaluation of the effectiveness of its internal control over financial reporting based on the framework described in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (the "COSO Framework"). Based on management's evaluation under the COSO Framework, Sterling's management has concluded that Sterling's internal control over financial reporting was effective as of December 31, 2005.

BDO Seidman, LLP, the independent registered public accounting firm that audited the financial statements included in Sterling's annual report on Form 10-K, has issued an attestation report on management's assessment of the effectiveness of Sterling's internal control over financial reporting as of December 31, 2005. The attestation report of BDO Seidman LLP is included herein.

**Table of Contents**

**Report of Independent Registered Public Accounting Firm**

The Board of Directors and Shareholders

Sterling Financial Corporation

Spokane, Washington

We have audited management's assessment, included in the accompanying Management's Report on Internal Control Over Financial Reporting, that Sterling Financial Corporation maintained effective internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Sterling Financial Corporation management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that Sterling Financial Corporation maintained effective internal control over financial reporting as of December 31, 2005, is fairly stated, in all material respects, based on the COSO criteria. Also in our opinion, Sterling Financial Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on the COSO criteria.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Sterling Financial Corporation as of December 31, 2005 and 2004, and the related consolidated statements of income, comprehensive income, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2005, of Sterling Financial Corporation and our report dated January 28, 2006, expressed an unqualified opinion.

BDO Seidman, LLP

Spokane, Washington

January 28, 2006



**Table of Contents**

**Item 9B. Other Information**

None.

**PART III**

**Item 10. Directors and Executive Officers of the Registrant**

In response to this Item, the information set forth in Sterling's Proxy Statement dated March 24, 2006, under the headings Board of Directors of Sterling Financial Corporation, Executive Officers, and Section 16(a) Beneficial Ownership Reporting Compliance is incorporated herein by reference.

Information concerning Sterling's Audit Committee financial expert is set forth under the caption Corporate Governance Committees of the Board of Directors in Sterling's Proxy Statement and is incorporated herein by reference.

Sterling has adopted a Code of Ethics that applies to all Sterling employees and directors, including Sterling's senior financial officers. The Code of Ethics is publicly available on Sterling's website at [www.sterlingsavingsbank.com](http://www.sterlingsavingsbank.com).

**Item 11. Executive Compensation**

In response to this Item, the information set forth in the Proxy Statement under the headings Personnel Committee Report on Executive Compensation and Executive Compensation is incorporated herein by reference.

**Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters**

In response to this Item, the information set forth in the Proxy Statement under the headings Security Ownership of Certain Beneficial Owners, Security Ownership of Management and Equity Compensation Plan Information is incorporated herein by reference.

**Item 13. Certain Relationships and Related Transactions**

In response to this Item, the information set forth in the Proxy Statement under the heading Interest of Directors, Officers and Others in Certain Transactions is incorporated herein by reference.

**Item 14. Principal Accounting Fees and Services**

In response to this Item, the information set forth in the Proxy Statement under the headings Ratification of Appointment of Independent Registered Public Accounting Firm, Audit Committee Report, and Independent Public Accounting Firm's Fees is incorporated herein by reference.

**Table of Contents**

**PART IV**

**Item 15. Exhibits, Financial Statement Schedules**

(a) Documents which are filed as a part of this report:

1. Financial Statements: The required financial statements are contained in pages F-1 through F-45 of this Form 10-K.
2. Financial Statement Schedules: Financial statement schedules have been omitted as they are not applicable or the information is included in the Consolidated Financial Statements.
3. 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.

(b) See (a)(3) above for all exhibits filed herewith.

(c) All schedules are omitted as the required information is not applicable or the information is presented in the Consolidated Financial Statements or related notes.

**Table of Contents**

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, as amended, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

STERLING FINANCIAL CORPORATION

March 15, 2006 By /s/ Harold B. Gilkey

**Harold B. Gilkey**

Chairman of the Board, Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

March 15, 2006 By /s/ Harold B. Gilkey

**Harold B. Gilkey**

Chairman of the Board, Chief Executive Officer,  
Principal Executive Officer

March 15, 2006 By /s/ William W. Zuppe

**William W. Zuppe**

President, Chief Operating Officer, Director

March 15, 2006 By /s/ Daniel G. Byrne

**Daniel G. Byrne**

Executive Vice President, Assistant Secretary and  
Principal Financial Officer

March 15, 2006 By /s/ William R. Basom

**William R. Basom**

Vice President, Treasurer and Principal Accounting Officer

March 15, 2006 By /s/ Rodney W. Barnett

**Rodney W. Barnett, Director**

March 15, 2006 By /s/ Donald N. Bauhofer

**Donald N. Bauhofer, Director**

March 15, 2006 By /s/ William L. Eisenhart

**William L. Eisenhart, Director**

March 15, 2006 By /s/ James P. Fugate

**James P. Fugate, Director**

March 15, 2006

By /s/ Robert D. Larrabee

**Robert D. Larrabee**, Director

March 15, 2006

By /s/ Donald J. Lukes

**Donald J. Lukes**, Director

59

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**Table of Contents**

**Report of Independent Registered Public Accounting Firm**

The Board of Directors and Shareholders

Sterling Financial Corporation

Spokane, Washington

We have audited the accompanying consolidated balance sheets of Sterling Financial Corporation as of December 31, 2005 and 2004, and the related consolidated statements of income, comprehensive income, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2005. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Sterling Financial Corporation at December 31, 2005 and 2004, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2005, in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Sterling Financial Corporation's internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated January 28, 2006, expressed an unqualified opinion thereon.

BDO Seidman, LLP

Spokane, Washington

January 28, 2006

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**Table of Contents**

**Sterling Financial Corporation**  
**Consolidated Balance Sheets**  
**December 31, 2005 and 2004**  
(Dollars in thousands)

|  | 2005         | 2004         |
|--|--------------|--------------|
| <b>ASSETS:</b>   |              |              |
| Cash and cash equivalents:   |              |              |
| Interest bearing   | \$ 9,400     | \$ 0         |
| Noninterest bearing and vault  | 121,907      | 93,187       |
| Restricted   | 862          | 1,281        |
| Investments and mortgage-backed securities ( MBS ):  |              |              |
| Available for sale   | 2,076,615    | 2,157,136    |
| Held to maturity   | 51,924       | 47,449       |
| Loans receivable, net  | 4,885,916    | 4,251,877    |
| Loans held for sale  | 7,894        | 14,224       |
| Accrued interest receivable  | 35,805       | 27,479       |
| Real estate owned, net   | 779          | 1,865        |
| Office properties and equipment, net   | 82,432       | 78,402       |
| Bank-owned life insurance ( BOLI )   | 107,649      | 93,790       |
| Goodwill   | 112,707      | 112,398      |
| Other intangible assets  | 17,625       | 19,848       |
| Mortgage servicing rights, net   | 5,430        | 4,078        |
| Prepaid expenses and other assets, net   | 41,983       | 39,210       |
| Total assets   | \$ 7,558,928 | \$ 6,942,224 |
| <b>LIABILITIES:</b>  |              |              |
| Deposits   | \$ 4,806,301 | \$ 3,863,296 |
| Advances from Federal Home Loan Bank of Seattle ( FHLB Seattle )   | 1,443,462    | 1,635,933    |
| Securities sold subject to repurchase agreements and funds purchased   | 611,676      | 780,012      |
| Other borrowings   | 110,688      | 131,822      |
| Cashiers checks issued and payable   | 5,483        | 3,213        |
| Borrowers reserves for taxes and insurance   | 1,527        | 2,480        |
| Accrued interest payable   | 18,169       | 14,842       |
| Accrued expenses and other liabilities   | 54,937       | 40,782       |
| Total liabilities  | 7,052,243    | 6,472,380    |
| Commitments and contingencies (Notes 9, 10, 11, 17, 18 and 25)   |              |              |
| <b>SHAREHOLDERS EQUITY:</b>  |              |              |
| 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; 34,855,549 and 22,936,154 shares issued and outstanding | 34,856       | 22,936       |
| Additional paid-in capital   | 385,353      | 393,245      |

|   |              |              |
|---|--------------|--------------|
| Accumulated other comprehensive loss:   |              |              |
| Unrealized losses on investments and MBS available-for-sale, net of deferred income taxes of \$20,021 and \$5,467 | (34,219)     | (9,470)      |
| Retained earnings   | 120,695      | 63,133       |
| Total shareholders' equity  | 506,685      | 469,844      |
| Total liabilities and shareholders' equity  | \$ 7,558,928 | \$ 6,942,224 |

*See accompanying summary of significant accounting policies and notes to consolidated financial statements.* **F-2**

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**Table of Contents**

**Sterling Financial Corporation**  
**Consolidated Statements of Income**  
**For the Years Ended December 31, 2005, 2004 and 2003**  
(Dollars in thousands, except per share amounts)

|  | <b>2005</b> | <b>2004</b> | <b>2003</b> |
|--|-------------|-------------|-------------|
| <b>Interest income:</b>                                      |             |             |             |
| Loans  | \$ 296,306  | \$ 229,448  | \$ 169,411  |
| MBS  | 88,682      | 85,009      | 41,193      |
| Investments and cash equivalents                             | 2,823       | 5,304       | 4,123       |
| Total interest income  | 387,811     | 319,761     | 214,727     |
| <b>Interest expense:</b>                                     |             |             |             |
| Deposits   | 91,990      | 53,483      | 36,831      |
| Short-term borrowings  | 35,255      | 23,787      | 11,753      |
| Long-term borrowings   | 44,031      | 45,675      | 41,223      |
| Total interest expense                                       | 171,276     | 122,945     | 89,807      |
| Net interest income  | 216,535     | 196,816     | 124,920     |
| <b>Provision for losses on loans:</b>                        | (15,200)    | (12,150)    | (10,500)    |
| Net interest income after provision for losses on loans      | 201,335     | 184,666     | 114,420     |
| <b>Non-interest income:</b>                                  |             |             |             |
| Fees and service charges                                     | 34,702      | 32,692      | 19,168      |
| Mortgage banking operations                                  | 17,899      | 6,155       | 8,482       |
| Loan servicing fees  | 434         | 561         | 566         |
| Net gains (losses) on sales of securities                    | (57)        | 4,571       | 3,694       |
| Real estate owned and other collateralized assets operations | 477         | (162)       | (73)        |
| BOLI   | 5,914       | 4,340       | 3,742       |
| Gain (charge) related to early repayment of debt             | 645         | (238)       | (1,464)     |
| Other non-interest expense                                   | (445)       | (120)       | (380)       |
| Total non-interest income                                    | 59,569      | 47,799      | 33,735      |
| <b>Non-interest expenses (Note 19)</b>                       | 170,281     | 148,370     | 94,564      |
| Income before income taxes                                   | 90,623      | 84,095      | 53,591      |
| <b>Income tax benefit (provision)</b>                        |             |             |             |
| Current  | (23,192)    | (19,030)    | (25,558)    |
| Deferred   | (6,212)     | (8,760)     | 6,880       |



|   |            |            |            |
|---|------------|------------|------------|
| Total tax provision                         | (29,404)   | (27,790)   | (18,678)   |
| <b>Net income</b>                           | \$ 61,219  | \$ 56,305  | \$ 34,913  |
| Earnings per share basic                    | \$ 1.77    | \$ 1.66    | \$ 1.45    |
| Earnings per share diluted                  | \$ 1.75    | \$ 1.62    | \$ 1.42    |
| Weighted average shares outstanding basic   | 34,633,952 | 33,931,509 | 23,980,113 |
| Weighted average shares outstanding diluted | 35,035,029 | 34,708,794 | 24,590,172 |

*See accompanying summary of significant accounting policies and notes to consolidated financial statements.* **F-3**

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**Table of Contents**

**Sterling Financial Corporation**  
**Consolidated Statements of Comprehensive Income**  
**For the Years Ended December 31, 2005, 2004 and 2003**  
(Dollars in thousands)

|  | <b>2005</b> | <b>2004</b> | <b>2003</b> |
|--|-------------|-------------|-------------|
| Net income   | \$ 61,219   | \$ 56,305   | \$ 34,913   |
| Other comprehensive income (loss):   |             |             |             |
| Change in unrealized gains or losses on investments and MBS<br>available for sale, net of reclassification adjustments | (39,303)    | 8,437       | (28,665)    |
| Less deferred income tax benefit (provision)   | 14,554      | (2,714)     | 10,033      |
| Net other comprehensive income (loss)  | (24,749)    | 5,723       | (18,632)    |
| Comprehensive income   | \$ 36,470   | \$ 62,028   | \$ 16,281   |

*See accompanying summary of significant accounting policies and notes to consolidated financial statements.* **F-4**

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**Table of Contents**

**Sterling Financial Corporation**  
**Consolidated Statements of Changes in Shareholders' Equity**  
**For the Years Ended December 31, 2005, 2004 and 2003**  
(Dollars in thousands)

|  | Common Stock |           | Additional         | Other                             | Retained  | Total                  |
|--|--------------|-----------|--------------------|-----------------------------------|-----------|------------------------|
|  | Shares       | Amount    | Paid-In<br>Capital | Comprehensive<br>Income<br>(Loss) | Earnings  | Shareholders<br>Equity |
| <b>Balance, January 1, 2003</b>  | 11,958,948   | \$ 11,959 | \$ 125,177         | \$ 3,439                          | \$ 63,081 | \$ 203,656             |
| Shares issued upon exercise of stock options   | 161,414      | 162       | 1,061              |                                   |           | 1,223                  |
| Shares issued for business combination   | 1,401,370    | 1,401     | 27,817             |                                   |           | 29,218                 |
| Change in unrealized gain or loss on investments and MBS available for sale, net of income tax |              |           |                    | (18,632)                          |           | (18,632)               |
| 10% common stock dividend  | 1,343,599    | 1,343     | 27,356             |                                   | (28,699)  |                        |
| Cash paid for fractional shares  | (1,414)      | (1)       | (29)               |                                   |           | (30)                   |
| Net income   |              |           |                    |                                   | 34,913    | 34,913                 |
| <b>Balance, December 31, 2003</b>  | 14,863,917   | 14,864    | 181,382            | (15,193)                          | 69,295    | 250,348                |
| Shares issued upon exercise of stock options   | 565,638      | 566       | 6,074              |                                   |           | 6,640                  |
| Shares issued for business combination   | 5,455,269    | 5,455     | 140,485            |                                   |           | 145,940                |
| Change in unrealized gain or loss on investments and MBS available for sale, net of income tax |              |           |                    | 5,723                             |           | 5,723                  |
| 10% common stock dividend  | 2,053,421    | 2,053     | 60,414             |                                   | (62,467)  |                        |
| Cash paid for fractional shares  | (2,091)      | (2)       | (61)               |                                   |           | (63)                   |
| Tax benefit of stock options   |              |           | 4,951              |                                   |           | 4,951                  |
| Net income   |              |           |                    |                                   | 56,305    | 56,305                 |
| <b>Balance, December 31, 2004</b>  | 22,936,154   | 22,936    | 393,245            | (9,470)                           | 63,133    | 469,844                |

|  |            |           |            |             |            |            |
|--|------------|-----------|------------|-------------|------------|------------|
| Shares issued upon exercise of stock options   | 366,696    | 367       | 3,044      |             |            | 3,411      |
| Change in unrealized gain or loss on investments and MBS available for sale, net of income tax |            |           |            | (24,749)    |            | (24,749)   |
| Stock split three for two  | 11,553,249 | 11,553    | (11,553)   |             |            |            |
| Cash paid for fractional shares  | (550)      |           | (14)       |             |            | (14)       |
| Cash dividends   |            |           |            |             | (3,657)    | (3,657)    |
| Tax benefit of stock options   |            |           | 631        |             |            | 631        |
| Net income   |            |           |            |             | 61,219     | 61,219     |
| <b>Balance, December 31, 2005</b>  | 34,855,549 | \$ 34,856 | \$ 385,353 | \$ (34,219) | \$ 120,695 | \$ 506,685 |

*See accompanying summary of significant accounting policies and notes to consolidated financial statements.* **F-5**

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**Table of Contents**

**Sterling Financial Corporation**  
**Consolidated Statements of Cash Flows**  
**For the Years Ended December 31, 2005, 2004 and 2003**  
(Dollars in thousands)

|   | 2005        | 2004        | 2003        |
|---|-------------|-------------|-------------|
| <b>Cash flows from operating activities:</b>                                      |             |             |             |
| Net income  | \$ 61,219   | \$ 56,305   | \$ 34,913   |
| Adjustments to reconcile net income to net cash provided by operating activities: |             |             |             |
| Provisions for losses on loans and real estate owned                              | 15,223      | 12,155      | 10,680      |
| Stock dividends on FHLB Seattle stock   | (303)       | (1,994)     | (2,682)     |
| Net gain on sales of loans, investments and MBS                                   | (10,219)    | (7,093)     | (9,412)     |
| Other gains and losses  | (103)       | 117         | 164         |
| Gain related to early repayment of debt   | (645)       | 0           | 0           |
| Change in cash surrender value of BOLI  | (5,914)     | (4,340)     | (3,742)     |
| Depreciation and amortization   | 20,063      | 14,289      | 12,271      |
| Deferred income tax (provision) benefit   | (6,212)     | 8,760       | 6,880       |
| Change in:  |             |             |             |
| Accrued interest receivable   | (8,326)     | (4,437)     | (1,635)     |
| Prepaid expenses and other assets   | 17,375      | 1,955       | 1,375       |
| Cashiers checks issued and payable  | 2,270       | (14,411)    | 2,318       |
| Accrued interest payable  | 3,327       | 4,505       | 322         |
| Accrued expenses and other liabilities  | 10,734      | (7,934)     | (4,804)     |
| Proceeds from sales of loans originated for sale                                  | 182,538     | 205,899     | 417,880     |
| Loans originated for sale   | (178,718)   | (203,378)   | (412,162)   |
| Net cash provided by operating activities   | 102,309     | 60,398      | 52,366      |
| <b>Cash flows from investing activities:</b>                                      |             |             |             |
| Change in restricted cash   | 419         | 223         | 22          |
| Loans funded and purchased  | (3,732,692) | (3,102,775) | (2,258,247) |
| Loan principal received   | 2,619,152   | 2,308,746   | 1,803,824   |
| Proceeds from sales of other loans  | 472,682     | 0           | 0           |
| Purchase of investments securities  | (17,152)    | (239,438)   | (6,089)     |
| Proceeds from maturities of investments securities                                | 2,604       | 226,535     | 2,627       |
| Proceeds from sales of investments securities                                     | 14,844      | 97,597      | 14,881      |
| Cash and cash equivalents acquired as part of mergers                             | 0           | 44,031      | 143,631     |
| Purchase of BOLI  | (10,000)    | 0           | (10,000)    |
| Purchase of mortgage-backed securities  | (471,715)   | (1,312,581) | (1,245,335) |
| Principal payments on MBS   | 385,126     | 353,175     | 279,343     |
| Proceeds from sales of MBS  | 115,837     | 537,672     | 694,023     |
| Purchase of office properties and equipment                                       | (12,901)    | (10,623)    | (7,442)     |
| Sale of office properties and equipment   | 268         | 0           | 0           |
| Improvements and other changes to real estate owned                               | (331)       | 241         | (282)       |
| Proceeds from sales and liquidation of real estate owned                          | 4,104       | 6,705       | 3,986       |
| Net cash used in investing activities   | (629,755)   | (1,090,492) | (585,058)   |

*See accompanying summary of significant accounting policies and notes to consolidated financial statements.*

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**F-6**

**Table of Contents**

**Sterling Financial Corporation**  
**Consolidated Statements of Cash Flows, Continued**  
**For the Years Ended December 31, 2005, 2004 and 2003**  
(Dollars in thousands)

|  | 2005        | 2004        | 2003        |
|--|-------------|-------------|-------------|
| <b>Cash flows from financing activities:</b>                                       |             |             |             |
| Net change in checking, regular savings and money market deposits                  | \$ 302,593  | \$ 139,333  | \$ 153,046  |
| Proceeds from issuance of time deposits  | 2,749,173   | 2,050,289   | 1,586,006   |
| Payments for maturing time deposits  | (2,195,593) | (1,819,944) | (1,518,327) |
| Interest credited to deposits  | 86,832      | 50,399      | 36,032      |
| Advances from FHLB Seattle   | 1,204,777   | 1,401,062   | 635,589     |
| Repayment of advances from FHLB Seattle  | (1,395,513) | (1,150,896) | (493,526)   |
| Net change in securities sold subject to repurchase agreements and funds purchased | (168,336)   | 416,875     | 113,368     |
| Proceeds from other borrowings   | 0           | 0           | 54,000      |
| Repayment of other borrowings  | (19,000)    | (36,995)    | (46,099)    |
| Payments for fractional shares and merger costs                                    | (14)        | (240)       | (30)        |
| Proceeds from exercise of stock options, net of repurchases                        | 3,411       | 7,083       | 1,223       |
| Deferred financing costs   | (75)        | 0           | (732)       |
| Cash dividend paid to shareholders   | (1,736)     | 0           | 0           |
| Other  | (953)       | 836         | (242)       |
| Net cash provided by financing activities  | 565,566     | 1,057,802   | 520,308     |
| Net change in cash and cash equivalents  | 38,120      | 27,708      | (12,384)    |
| Cash and cash equivalents, beginning of year                                       | 93,187      | 65,479      | 77,863      |
| Cash and cash equivalents, end of year   | \$ 131,307  | \$ 93,187   | \$ 65,479   |
| <b>Supplemental disclosures:</b>   |             |             |             |
| Cash paid during the period for:   |             |             |             |
| Interest   | \$ 167,949  | \$ 116,326  | \$ 87,928   |
| Income taxes   | 11,377      | 17,427      | 17,976      |
| Noncash financing and investing activities:  |             |             |             |
| Loans converted into real estate owned   | 2,271       | 3,858       | 3,124       |
| Common stock issued upon business combination                                      | 0           | 145,940     | 29,218      |
| Common stock cash dividend accrued   | 1,921       | 0           | 0           |
| Common stock dividend  | 0           | 62,467      | 28,699      |
| Common stock split, effected as dividend   | 11,553      | 0           | 0           |

*See accompanying summary of significant accounting policies and notes to consolidated financial statements.* **F-7**





**Table of Contents**

**Sterling Financial Corporation  
Summary of Significant Accounting Policies  
For the Years Ended December 31, 2005, 2004 and 2003**

**Business**

Sterling Financial Corporation ( Sterling ) is a bank holding company, the significant operating subsidiary of which is Sterling 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.

Sterling provides personalized, quality financial services to its customers as exemplified by its Hometown Helpful® philosophy. Sterling believes that this dedication to personalized service has enabled it to grow both its retail deposit base and its lending portfolio in the Pacific Northwest region. With \$7.56 billion in total assets at December 31, 2005, Sterling attracts Federal Deposit Insurance Corporation ( FDIC ) insured deposits from the general public through 140 retail branches located in Washington, Oregon, Idaho and Montana. Sterling originates loans through branch offices, as well as Action Mortgage residential loan production offices in the four-state area, as well as Utah and through INTERVEST commercial real estate lending offices in Washington, Oregon, Arizona and California. Sterling also markets fixed income and equity products, mutual funds, fixed and variable annuities and many other financial products through Harbor Financial.

**Principles of Consolidation**

The accompanying consolidated financial statements include the accounts of Sterling and its directly and indirectly wholly owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

**Estimates**

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 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.

**Cash and Cash Equivalents**

Cash equivalents include investments with a remaining maturity of three months or less at the date of purchase. Cash and cash equivalents are deposited with other banks and financial institutions in amounts that may at times exceed the federal insurance limit. Sterling evaluates the credit quality of these banks and financial institutions to mitigate its credit risk.

Restricted cash consists primarily of non-interest bearing deposits maintained as a reserve at the Federal Reserve Bank.

Sterling occasionally purchases securities under agreements with another institution to resell the same or similar securities. The amounts advanced under these agreements represent short-term loans and are reflected as interest bearing cash equivalents in the consolidated balance sheet. The securities underlying the agreements are comprised of mutual fund shares that are primarily invested in U.S. government securities.

**F-8**

**Table of Contents**

**Sterling Financial Corporation  
Summary of Significant Accounting Policies  
For the Years Ended December 31, 2005, 2004 and 2003**

**Investments and MBS**

Sterling classifies debt and equity investments and MBS as follows:

*Available for Sale.* Except for FHLB Seattle stock, debt and equity investments and MBS that will be held for indefinite periods of time are classified as available for sale and are carried at market value. Market value is determined using published quotes or other indicators of value as of the close of business on December 31, 2005 and 2004. Unrealized gains and losses are reported, net of deferred income taxes, as a component of accumulated other comprehensive income or loss in shareholders' equity until realized.

FHLB Seattle (class B1) stock may only be redeemed by FHLB Seattle or sold to other member institutions at par. Therefore, while FHLB stock is classified as available for sale, the investment is restricted and is carried at cost.

*Held to Maturity.* Investments in debt securities that management of Sterling has the intent and ability to hold until maturity are classified as held to maturity and are carried at their remaining unpaid principal balance, net of unamortized premiums or unaccreted discounts.

Premiums are amortized and discounts are accreted using the level interest yield method over the estimated remaining term of the underlying security. Realized gains and losses on sales of investments and MBS are recognized in the statement of income in the period sold using the specific identification method.

**Loans Receivable**

Loans receivable that management of Sterling has the intent and ability to hold for the foreseeable future or until maturity or pay-off are reported at their outstanding principal balance less any unamortized origination and commitment fees, net of direct loan origination costs and an associated allowance for losses on loans.

Interest income is recognized over the term of the loans receivable on a level yield basis. The accrual of interest on impaired loans is discontinued when, in management's opinion, the borrower may be unable to make payments as they become due. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received.

**Allowance for Losses on Loans**

The allowance for loan losses is maintained at a level deemed appropriate by management to adequately provide for known and probable losses and inherent risks in the loan portfolio. Sterling has a systematic methodology for determining an appropriate allowance for loan losses. The allowance is based upon a number of factors, including prevailing and anticipated economic trends, industry experience, estimated collateral values, management's assessment of credit risk inherent in the portfolio, delinquency trends, historical loss experience, specific problem loans and other relevant factors. As a result of changing economic conditions, it is reasonably possible that the amount or adequacy of the allowance for losses on loans could change.

Additions to the allowance, in the form of provisions, are reflected in current operating results, while charge-offs to the allowance are made when a loss is determined to have occurred. Because the allowance for loan losses is based on estimates, ultimate losses may vary from the current estimates.

A loan is considered impaired, based on current information and events, if it is probable that Sterling will be unable to collect the scheduled payments of principal and interest when due according to the contractual terms of the loan agreement. Any allowance on impaired loans is generally based on one of three methods. Impaired loans are measured at either, 1) the present value of expected cash flows at the loan's effective interest rate, 2) the loan's observable market price, or 3) the fair value of the collateral of the loan.

**F-9**

**Table of Contents**

**Sterling Financial Corporation  
Summary of Significant Accounting Policies  
For the Years Ended December 31, 2005, 2004 and 2003**

**Loans Held for Sale**

Loans held for sale are reported at the lower of amortized cost or market value as determined on an aggregate basis. Any loan that management determines will not be held to maturity is classified as held for sale. Market value is determined for loan pools of common interest rates using published quotes as of the balance sheet date. Unrealized losses on loans held for sale are included in the consolidated statements of income in the period that the unrealized loss is identified.

**Loan Origination and Commitment Fees**

Loan origination fees, net of direct origination costs, are deferred and recognized as interest income using the level interest yield method or methods that approximate the level yield method over the contractual term of each loan adjusted for actual loan prepayment experience. If the related loan is sold, the remaining net amount, which is part of the basis of the loan, is considered in determining the gain or loss on sale.

Loan commitment fees are deferred until the expiration of the commitment period unless management believes there is a remote likelihood that the underlying commitment will be exercised, in which case the fees are amortized to fee income using the straight-line method over the commitment period. If a loan commitment is exercised, the deferred commitment fee is accounted for in the same manner as a loan origination fee. Deferred commitment fees associated with expired commitments are recognized as fee income.

**Office Properties and Equipment**

Office properties and equipment are carried at cost less accumulated depreciation and amortization. Depreciation and amortization are computed using the straight-line method over the lesser of the estimated useful lives or the related lease terms of the assets. Expenditures for new properties and equipment and major renewals or betterments are capitalized. Expenditures for repairs and maintenance are charged to expense as incurred. Upon sale or retirement, the cost and related accumulated depreciation are removed from the respective property or equipment accounts, and the resulting gains or losses are reflected in operations.

**Real Estate Owned**

Property and other assets acquired through foreclosure of defaulted mortgage loans are carried at the lower of cost or fair value less estimated costs to sell. Development and improvement costs relating to the property are capitalized to the extent they are deemed to be recoverable. The carrying value of the property is periodically evaluated by management and, if necessary, allowances are established to reduce the carrying value to net realizable value.

**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.

**F-10**

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**Table of Contents**

**Sterling Financial Corporation**

**Summary of Significant Accounting Policies**

**For the Years Ended December 31, 2005, 2004 and 2003**

**Goodwill and Other Intangible Assets, Continued:**

Sterling's management performed the annual test of its goodwill and other intangible assets as of June 30, 2005, 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.

**Loan Purchases**

In accordance with the American Institute of Certified Public Accountants' Statement of Position (SOP) 03-3,

Accounting for Certain Loans or Debt Securities Acquired in a Transfer, loans acquired at a discount, when the discount is in part attributable to credit quality, should not have interest accrued on them at the coupon rate, but at a rate that is discounted for the credit quality issues. Changes in the estimates of cash flows will require an adjustment to the accrual rate. Sterling considers this guidance when entering into applicable transactions. Sterling paid premiums for loan purchases entered into during the effective time of this SOP, with substandard loans being withdrawn from the pools.

**Mortgage Banking Operations**

Sterling, through Action Mortgage and INTERVEST, originates and sells loans and participating interests in loans to provide additional funds for general corporate purposes. Loans and participating interests therein are held for sale and are carried at the lower of cost or market value. Sterling recognizes a gain or loss on these loan sale transactions, which include a component reflecting the differential between the contractual interest rate of the loan and the interest rate, which will be received by the investor. The present value of the estimated future profit for servicing the loans, together with the normal servicing fee rate and changes in the fair value of any derivatives, is taken into account in determining the amount of gain or loss on the sale of loans.

At December 31, 2005 and 2004, mortgage servicing rights were approximately \$5.4 million and \$4.1 million, respectively, which are net of accumulated amortization of approximately \$5.2 million and \$3.3 million, respectively. The initial valuation of mortgage servicing rights is based on the relative fair value of the servicing rights and the loan that was sold. The cost of mortgage servicing rights is amortized in proportion to, and over the period of, estimated net servicing revenues. Impairment of mortgage servicing rights is assessed based on the fair value of those rights. Fair values are estimated using discounted cash flows based on a current market interest rate. For purposes of measuring impairment, the rights are stratified based primarily on prepayment and interest rate risks. The amount of impairment recognized is the amount by which the capitalized mortgage servicing rights for a stratum exceeds their fair value.

**Income Taxes**

Sterling accounts for income taxes using the liability method, which requires that deferred tax assets and liabilities be determined based on the temporary differences between the financial statement carrying amounts and the tax basis of assets and liabilities, and the tax attributes using enacted tax rates in effect in the years in which the temporary differences are expected to reverse.

**Earnings Per Share**

Earnings per share - basic is computed by dividing net income by the weighted average number of shares outstanding during the period. Earnings per share - diluted is computed by dividing net income by the weighted average number of shares outstanding, increased by the additional shares that would have been outstanding if all potentially dilutive and contingently issuable shares had been issued.

**Table of Contents**

**Sterling Financial Corporation**  
**Summary of Significant Accounting Policies**  
**For the Years Ended December 31, 2005, 2004 and 2003**

**Stock-Based Compensation**

As permitted by the Financial Accounting Standards Board ( FASB ) Statement of Financial Accounting Standards ( SFAS ) No. 123, Accounting for Stock-Based Compensation ( SFAS No. 123 ), Sterling elected to retain the compensation measurement principles of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees ( APB No. 25 ), and its related interpretations, for stock options. Under APB No. 25, compensation cost is recognized at the measurement date of the amount, if any, that the quoted market price of Sterling s common stock exceeds the option exercise price. Sterling grants its common stock options to employees with exercise prices equal to the market price of Sterling s common stock on the measurement date. Thus, no compensation cost is recognized. Sterling has chosen not to record compensation expense using fair value measurement provisions in the statement of income. See New Accounting Policies for guidance on the effect of the FASB s revision of SFAS No. 123. Had compensation cost for Sterling s plans been determined based on the fair value at the grant dates for awards under the plans, Sterling s reported net income and earnings per share would have been changed to the pro forma amounts indicated below (dollars in thousands, except per share amounts):

|   | <b>Years Ended December 31,</b> |             |             |
|---|---------------------------------|-------------|-------------|
|   | <b>2005</b>                     | <b>2004</b> | <b>2003</b> |
| Reported net income:  | \$ 61,219                       | \$ 56,305   | \$ 34,913   |
| Add back: Stock-based employee compensation expense, net of related tax effects   | 0                               | 0           | 0           |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | (3,319)                         | (7,331)     | (2,486)     |
| Pro forma net income  | \$ 57,900                       | \$ 48,974   | \$ 32,427   |
| Basic earnings per share:   |                                 |             |             |
| Reported earnings per share   | \$ 1.77                         | \$ 1.66     | \$ 1.45     |
| Stock-based employee compensation, fair value   | (0.10)                          | (0.22)      | (0.10)      |
| Pro forma earnings per share  | \$ 1.67                         | \$ 1.44     | \$ 1.35     |
| Diluted earnings per share:   |                                 |             |             |
| Reported earnings per share   | \$ 1.75                         | \$ 1.62     | \$ 1.42     |
| Stock-based employee compensation, fair value   | (0.09)                          | (0.21)      | (0.10)      |
| Pro forma earnings per share  | \$ 1.66                         | \$ 1.41     | \$ 1.32     |

A significant portion of the options granted in 2004 and 2003 vested in 2004. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions used:

|                     | <b>Years Ended December 31,</b> |             |             |
|---------------------|---------------------------------|-------------|-------------|
|                     | <b>2005</b>                     | <b>2004</b> | <b>2003</b> |
| Expected volatility | 32%                             | 37% - 132%  | 85% - 132%  |

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|                           |                       |                  |                  |
|---------------------------|-----------------------|------------------|------------------|
| Expected lives (in years) | 2.9 -<br>5.4<br>4.37% | 4 - 10           | 4 - 10           |
| Risk free interest rates  | -<br>4.44%            | 1.77% -<br>6.52% | 2.86% -<br>6.52% |
| Expected forfeiture rate  | 0%<br>0.87%           | 0%               | 0%               |
| Annual dividend yield     | -<br>1.04%            | 0%               | 0%               |

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**F-12**

**Table of Contents**

**Sterling Financial Corporation**  
**Summary of Significant Accounting Policies**  
**For the Years Ended December 31, 2005, 2004 and 2003**

**Comprehensive Income**

Sterling has adopted SFAS No. 130, Reporting Comprehensive Income ( SFAS No. 130 ). SFAS No. 130 establishes standards for reporting and display of comprehensive income and its components (revenues, expenses, gains and losses) in a full set of general-purpose financial statements.

Reclassification adjustments, representing the net (gains) losses on available-for-sale securities that were realized during the period, net of related deferred income taxes, were as follows (in thousands):

|                              | <b>Amount</b> |
|------------------------------|---------------|
| Year ended December 31, 2005 | \$ (64)       |
| Year ended December 31, 2004 | 464           |
| Year ended December 31, 2003 | (2,046)       |

These (gains) losses had previously been included in other comprehensive income as unrealized (gains) losses on investments and MBS available for sale.

**Hedging Activities**

Sterling, through its subsidiary Action Mortgage, enters into interest rate lock commitments to prospective residential mortgage borrowers. Action Mortgage hedges interest rate risk ( IRR ) by entering into nonbinding ( best efforts ) forward sales agreements with third parties. In addition, to improve and protect the profit margin on loans sold into the secondary market, Action Mortgage hedges IRR by entering into binding ( mandatory ) forward sales agreements on MBS with third parties.

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

Rate lock commitments and forward sales agreements are considered to be derivatives. Sterling has recorded the estimated fair values of the rate lock commitments and forward sales agreements on its balance sheet in either other assets or other liabilities. Changes in the fair values of these derivative instruments are recorded in income from mortgage banking operations in the income statement as the changes occur. The estimated fair values of rate lock commitments and forward sales agreements as compared to the contracted amounts at December 31, 2005 resulted in an asset of \$147,000 and a liability of \$25,000, respectively. At December 31, 2004, rate lock commitments and forward sales agreements were assets of \$76,000 and \$12,000, respectively.

**Mergers and Acquisitions**

Pursuant to SFAS No. 141, Sterling's mergers and acquisitions are accounted for under the purchase method of accounting. Accordingly, the assets and liabilities of the acquired entities are recorded by Sterling at their respective fair values at the date of the acquisition and the results of operations are included with those of Sterling commencing with the date of acquisition. The excess of the purchase price over the net fair value of the assets acquired and liabilities assumed, including identifiable intangible assets, is recorded as goodwill.

**F-13**

**Table of Contents**

**Sterling Financial Corporation  
Summary of Significant Accounting Policies  
For the Years Ended December 31, 2005, 2004 and 2003**

**Reclassifications**

Certain amounts in prior period financial statements have been reclassified to conform to the current year's presentation. These reclassifications had no effect on retained earnings or net income as previously reported.

**Other Accounting Pronouncements**

In December 2004, the FASB issued SFAS No. 123 (revised 2004), Share-Based Payment, which established accounting standards for transactions involving the issuance of equity instruments to employees for services rendered. This statement is a revision of SFAS No. 123, and supersedes APB No. 25. This statement requires the estimation and recognition of the grant date fair value of stock options issued to employees. This statement is effective for Sterling as of January 1, 2006. Management has evaluated the effect of this new standard, and has determined that the cost of currently outstanding unvested stock options will not have a material effect on Sterling's consolidated financial statements. Management is currently evaluating what form, if any, of share based compensation it will implement in the future.

In November 2005, FASB Staff Position ( FSP ) No. 115-1 The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments, was released. This FSP addresses when an investment is considered impaired, whether that impairment is other than temporary, and the measurement of an impairment loss. This FSP requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. This FSP is effective for reporting periods beginning after December 15, 2005, with early application permitted. Sterling has applied this standard, and it did not have a material effect on the consolidated financial statements.

**F-14**

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**Table of Contents**

**Sterling Financial Corporation**  
**Notes to Consolidated Financial Statements**  
**For the Years Ended December 31, 2005, 2004 and 2003**

**1. Investments and MBS:**

The carrying and fair values of investments and MBS are summarized as follows (in thousands):

|  | <b>Amortized<br/>Cost</b> | <b>Available for Sale</b>             |  | <b>Carrying/Fair<br/>Value</b> |
|--|---------------------------|---------------------------------------|--|--------------------------------|
|  |                           | <b>Gross<br/>Unrealized<br/>Gains</b> | <b>Gross<br/>Unrealized<br/>Losses</b> |                                |
| <b>December 31, 2005</b>               |                           |                                       |  |                                |
| U.S. Government and agency obligations | \$ 21,976                 | \$ 1                                  | \$ (184)                               | \$ 21,793                      |
| FHLB Seattle stock (restricted)        | 76,626                    | 0                                     | 0                                      | 76,626                         |
| MBS                                    | 2,014,512                 | 188                                   | (54,118)                               | 1,960,582                      |
| Other                                  | 17,614                    | 0                                     | 0                                      | 17,614                         |
| Total                                  | \$ 2,130,728              | \$ 189                                | \$ (54,302)                            | \$ 2,076,615                   |

**December 31, 2004**

|  |              |          |             |              |
|--|--------------|----------|-------------|--------------|
| U.S. Government and agency obligations | \$ 28,089    | \$ 95    | \$ (114)    | \$ 28,070    |
| FHLB Seattle stock (restricted)        | 74,846       | 0        | 0           | 74,846       |
| MBS                                    | 2,051,676    | 4,991    | (19,747)    | 2,036,920    |
| Other                                  | 17,300       | 0        | 0           | 17,300       |
| Total                                  | \$ 2,171,911 | \$ 5,086 | \$ (19,861) | \$ 2,157,136 |

|                          | <b>Amortized<br/>Cost/<br/>Carrying<br/>Value</b> | <b>Held to Maturity</b>               |  | <b>Fair<br/>Value</b> |
|--------------------------|---|---------------------------------------|--|-----------------------|
|                          |   | <b>Gross<br/>Unrealized<br/>Gains</b> | <b>Gross<br/>Unrealized<br/>Losses</b> |                       |
| <b>December 31, 2005</b> |   |                                       |  |                       |
| Municipal bonds          | \$ 50,907   | \$ 224                                | \$ (400)                               | \$ 50,731             |
| Other                    | 1,017   | 0                                     | 0                                      | 1,017                 |
| Total                    | \$ 51,924   | \$ 224                                | \$ (400)                               | \$ 51,748             |
| <b>December 31, 2004</b> |   |                                       |  |                       |
| Municipal bonds          | \$ 47,449   | \$ 184                                | \$ (166)                               | \$ 47,467             |

At December 31, 2005 and 2004, accrued interest on investments and MBS was \$9.1 million and \$9.2 million, respectively.

**F-15**

**Table of Contents**

**Sterling Financial Corporation**  
**Notes to Consolidated Financial Statements**  
**For the Years Ended December 31, 2005, 2004 and 2003**

**1. Investments and MBS, Continued:**

During the years ended December 31, 2005, 2004 and 2003, Sterling sold available-for-sale investments and MBS which resulted in the following (in thousands):

|                              | <b>Proceeds<br/>from<br/>Sales</b> | <b>Gross<br/>Realized<br/>Gains</b> | <b>Gross<br/>Realized<br/>Losses</b> |
|------------------------------|------------------------------------|-------------------------------------|--------------------------------------|
| Year ended December 31, 2005 | \$ 130,681                         | \$ 442                              | \$ 499                               |
| Year ended December 31, 2004 | 635,269                            | 6,390                               | 1,819                                |
| Year ended December 31, 2003 | 708,904                            | 4,590                               | 896                                  |

At December 31, 2005, the amortized cost and fair value of available-for-sale and held-to-maturity debt securities, by contractual maturity (in thousands), are shown below. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

|  | <b>Amortized<br/>Cost</b> | <b>Fair Value</b> |
|--|---------------------------|-------------------|
| Available-for-sale MBS:                                    |                           |                   |
| 1 to 5 years   | \$ 16,318                 | \$ 15,628         |
| After 5 years through 10 years                             | 91,705                    | 88,828            |
| After 10 years   | 1,906,489                 | 1,856,126         |
|  | \$ 2,014,512              | \$ 1,960,582      |
| Available-for-sale U.S. Government and agency obligations: |                           |                   |
| Under 1 year   | \$ 7,969                  | \$ 7,956          |
| After 1 year through 5 years                               | 14,007                    | 13,837            |
|  | \$ 21,976                 | \$ 21,793         |
| Other available for sale:                                  |                           |                   |
| After 5 years through 10 years                             | \$ 1,500                  | \$ 1,500          |
| After 10 years   | 92,740                    | 92,740            |
|  | \$ 94,240                 | \$ 94,240         |
| Held-to-maturity municipal bonds:                          |                           |                   |
| Under 1 year   | \$ 350                    | \$ 354            |
| After 1 year through 5 years                               | 2,816                     | 2,806             |
| After 5 through 10 years                                   | 7,234                     | 7,160             |
| After 10 years   | 40,507                    | 40,411            |
|  | \$ 50,907                 | \$ 50,731         |
| Other held-to-maturities securities:                       |                           |                   |
| Under 1 year   | \$ 857                    | \$ 857            |

|                              |          |          |
|------------------------------|----------|----------|
| After 1 year through 5 years | 160      | 160      |
|                              | \$ 1,017 | \$ 1,017 |

**F-16**

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**Table of Contents**

**Sterling Financial Corporation**  
**Notes to Consolidated Financial Statements**  
**For the Years Ended December 31, 2005, 2004 and 2003**

**1. Investments and MBS, Continued:**

Pursuant to FSP No. 115-1, the following table summarizes Sterling's gross unrealized losses on temporarily impaired investments and MBS as of the dates indicated (in thousands):

|  | Less than 12 months |                   | 12 months or longer |                   | Total        |                   |
|--|---------------------|-------------------|---------------------|-------------------|--------------|-------------------|
|  | Market Value        | Unrealized Losses | Market Value        | Unrealized Losses | Market Value | Unrealized Losses |
| <b>December 31, 2005</b>               |                     |                   |                     |                   |              |                   |
| U.S. Government and agency obligations | \$ 19,754           | \$ (184)          | \$ 0                | \$ 0              | \$ 19,754    | \$ (184)          |
| Municipal bonds                        | 6,031               | (84)              | 26,490              | (316)             | 32,521       | (400)             |
| MBS                                    | 541,451             | (10,544)          | 890,661             | (36,737)          | 1,432,112    | (47,281)          |
| Collateralized mortgage obligations    | 416,705             | (5,496)           | 44,167              | (1,341)           | 460,872      | (6,837)           |
| Total                                  | \$ 983,941          | \$ (16,308)       | \$ 961,318          | \$ (38,394)       | \$ 1,945,259 | \$ (54,702)       |

**December 31, 2004**

|  |            |             |            |            |              |             |
|--|------------|-------------|------------|------------|--------------|-------------|
| U.S. Government and agency obligations | \$ 14,919  | \$ (114)    | \$ 0       | \$ 0       | \$ 14,919    | \$ (114)    |
| Municipal bonds                        | 27,089     | (166)       | 24         | 0          | 27,113       | (166)       |
| MBS                                    | 664,928    | (9,984)     | 417,597    | (9,240)    | 1,082,525    | (19,224)    |
| Collateralized mortgage obligations    | 39,933     | (194)       | 44,411     | (329)      | 84,344       | (523)       |
| Total                                  | \$ 746,869 | \$ (10,458) | \$ 462,032 | \$ (9,569) | \$ 1,208,901 | \$ (20,027) |

Sterling's investment and MBS portfolio is managed to provide and maintain liquidity, maintain a balance of high quality diversified investments to minimize risk, provide collateral for pledging and maximize returns. Management believes all unrealized losses as of December 31, 2005 to be market driven, with no permanent sector or issuer credit concerns or impairments. As such, Sterling's investments and MBS are believed to be temporarily, not permanently, impaired in value.

Sterling measures the impact of potential interest rate movements on both the balance sheet and the income statement as part of its regular asset and liability management process, and makes investment strategy decisions based upon consideration of both. As interest rate cycles can take many years to complete, substantial unrealized losses may be reflected on the balance sheet, while offsetting improvements in valuations of liabilities used for funding sources are not.

At December 31, 2005 and 2004, U.S. government and agency obligations and MBS with an aggregate fair value of \$68.7 million and \$113.0 million, respectively, were pledged as collateral for the treasury tax and loan account in accordance with Federal Reserve Board regulations or for wholesale public funds deposits in accordance with Washington, Oregon and Montana state laws and regulations. Additionally, Sterling periodically utilizes MBS as collateral for reverse repurchase agreements and other borrowing transactions. See Notes 9 and 10.



**Table of Contents**

**Sterling Financial Corporation**  
**Notes to Consolidated Financial Statements**  
**For the Years Ended December 31, 2005, 2004 and 2003**

**2. Loans Receivable:**

The components of loans receivable are as follows (in thousands):

|   | <b>December 31,</b> |              |
|---|---------------------|--------------|
|   | <b>2005</b>         | <b>2004</b>  |
| Real estate loans:                                  |                     |              |
| Variable rate:                                      |                     |              |
| 1-4 unit residential                                | \$ 81,201           | \$ 131,739   |
| 5 or more unit residential                          | 287,389             | 164,245      |
| Commercial  | 646,650             | 651,579      |
| Land and other                                      | 6,559               | 704          |
| Fixed rate:   |                     |              |
| Conventional 1-4 unit residential                   | 376,683             | 646,175      |
| 1-4 unit residential, insured by FHA/VA             | 628                 | 1,066        |
| 5 and 7 year balloon or reset 1-4 unit residential  | 11,432              | 7,104        |
| 5 or more unit residential                          | 44,822              | 20,509       |
| Commercial  | 145,431             | 48,005       |
| Land and other                                      | 12,268              | 8,140        |
| Construction:                                       |                     |              |
| 1-4 unit residential                                | 591,362             | 357,049      |
| 5 or more unit residential                          | 143,272             | 120,411      |
| Commercial  | 286,868             | 175,434      |
|   | 2,634,565           | 2,332,160    |
| Other loans:  |                     |              |
| Commercial loans                                    | 880,633             | 755,717      |
| Commercial and personal lines of credit             | 853,436             | 740,235      |
| Consumer loans                                      | 581,681             | 480,034      |
|   | 2,315,750           | 1,975,986    |
| Total loans receivable                              | 4,950,315           | 4,308,146    |
| Deferred loan fees, net of direct origination costs | (8,916)             | (6,907)      |
| Gross loans receivable                              | 4,941,399           | 4,301,239    |
| Allowance for losses on loans                       | (55,483)            | (49,362)     |
| Loans receivable, net                               | \$ 4,885,916        | \$ 4,251,877 |
| Weighted average interest rate                      | 6.89%               | 5.91%        |

Net accrued interest on loans receivable was approximately \$26.7 million and \$18.3 million at December 31, 2005 and 2004, respectively.

Sterling originates the majority of its loans throughout the Pacific Northwest. The value of real estate properties in the Pacific Northwest is affected by changes in the economic environment. It is reasonably possible that these values could change in the near term, which may adversely affect Sterling's estimate of its allowance for losses on loans associated with these loans receivable.

Sterling originates both variable and fixed-rate loans. The variable-rate loans have interest rate adjustment limitations and are generally indexed to various indices. Variable-rate real estate loans are typically indexed to the prime rate, one-year or five-year U.S. Treasury index, or periodic fixed-rate LIBOR swap curve. Future market factors may affect the correlation of the interest rates Sterling pays on the short-term deposits that have been primarily utilized to fund these loans.

**F-18**

---

**Table of Contents**

**Sterling Financial Corporation**  
**Notes to Consolidated Financial Statements**  
**For the Years Ended December 31, 2005, 2004 and 2003**

**2. Loans Receivable, Continued:**

At December 31, 2005, the contractual principal payments due on outstanding loans receivable (in thousands) are shown below. Actual payments may differ from expected payments because borrowers have the right to prepay loans, with or without prepayment penalties:

| <b>Years Ending December 31,</b> | <b>Amount</b> |
|----------------------------------|---------------|
| 2006                             | \$ 1,723,259  |
| 2007                             | 625,518       |
| 2008                             | 354,707       |
| 2009                             | 260,861       |
| 2010                             | 263,338       |
| Thereafter                       | 1,722,632     |
|                                  | \$ 4,950,315  |

Loan sales during 2005 resulted in gains of \$10.2 million versus 2004 gains of \$2.7 million, with the difference being primarily volume driven.

**3. Loan Servicing:**

Loans serviced for others are not included in the consolidated balance sheets. The unpaid principal balances of these loans as of the dates indicated are summarized as follows (in thousands):

|                               | <b>2005</b>  | <b>December 31,<br/>2004</b> | <b>2003</b> |
|-------------------------------|--------------|------------------------------|-------------|
| Loan portfolios serviced for: |              |                              |             |
| FHLMC                         | \$ 203,836   | \$ 180,641                   | \$ 184,931  |
| FNMA                          | 401,354      | 191,336                      | 143,157     |
| FHLB                          | 1,495        | 1,625                        | 1,317       |
| Other residential permanent   | 122          | 195                          | 205         |
| Commercial real estate        | 814,157      | 593,329                      | 211,539     |
| Other commercial              | 159          | 225                          | 0           |
| Consumer                      | 3,098        | 7,846                        | 25,927      |
|                               | \$ 1,424,221 | \$ 975,197                   | \$ 567,076  |

**F-19**



**Table of Contents**

**Sterling Financial Corporation**  
**Notes to Consolidated Financial Statements**  
**For the Years Ended December 31, 2005, 2004 and 2003**

**3. Loan Servicing, Continued:**

The following is an analysis of the changes in mortgage servicing rights (in thousands):

|                            | <b>Amount</b> |
|----------------------------|---------------|
| Balance, January 1, 2003   | \$ 1,680      |
| Originated servicing       | 2,553         |
| Amortization               | (1,113)       |
| Net write-up               | 380           |
| Balance, December 31, 2003 | 3,500         |
| Originated servicing       | 765           |
| Acquired servicing         | 924           |
| Amortization               | (1,179)       |
| Net write-up               | 68            |
| Balance, December 31, 2004 | 4,078         |
| Originated servicing       | 2,790         |
| Acquired servicing         | 316           |
| Amortization               | (1,754)       |
| Balance, December 31, 2005 | \$ 5,430      |

Sterling has sold participations in certain commercial real estate loans to investors on a servicing retained basis. During the years ended December 31, 2005, 2004 and 2003, Sterling sold approximately \$125.5 million, \$16.3 million and \$35.9 million in commercial real estate loans under participation agreements, resulting in net gains of \$449,000, \$44,000 and \$328,000, respectively.

**4. Real Estate Owned:**

The components of real estate owned are as follows (in thousands):

|                        | <b>December 31,</b> |             |
|------------------------|---------------------|-------------|
|                        | <b>2005</b>         | <b>2004</b> |
| Commercial             | \$ 358              | \$ 768      |
| Residential            | 250                 | 462         |
| Other                  | 188                 | 635         |
|                        | 796                 | 1,865       |
| Allowance for losses   | (17)                | 0           |
| Real estate owned, net | \$ 779              | \$ 1,865    |

---

**F-20**

**Table of Contents**

**Sterling Financial Corporation**  
**Notes to Consolidated Financial Statements**  
**For the Years Ended December 31, 2005, 2004 and 2003**

**5. Allowances for Losses on Loans and Real Estate Owned:**

The following is an analysis of the changes in the allowances for losses on loans and real estate owned (in thousands):

|   | <b>Loans</b>  | <b>Real<br/>Estate<br/>Owned</b> | <b>Total</b>  |
|---|---------------|----------------------------------|---------------|
| Balance, January 1, 2003                | \$ 27,866     | \$ 239                           | \$ 28,105     |
| Provision                               | 10,500        | 180                              | 10,680        |
| Allowance for losses on assets acquired | 870           | 0                                | 870           |
| Amounts written off                     | (4,253)       | (416)                            | (4,669)       |
| Recoveries                              | 622           | 0                                | 622           |
| <br>Balance, December 31, 2003          | <br>35,605    | <br>3                            | <br>35,608    |
| Provision                               | 12,150        | 5                                | 12,155        |
| Allowance for losses on assets acquired | 6,722         | 0                                | 6,722         |
| Amounts written off                     | (5,483)       | (8)                              | (5,491)       |
| Recoveries                              | 368           | 0                                | 368           |
| <br>Balance, December 31, 2004          | <br>49,362    | <br>0                            | <br>49,362    |
| Provision                               | 15,200        | 23                               | 15,223        |
| Amounts written off                     | (9,651)       | (6)                              | (9,657)       |
| Recoveries                              | 572           | 0                                | 572           |
| <br>Balance, December 31, 2005          | <br>\$ 55,483 | <br>\$ 17                        | <br>\$ 55,500 |

The following is a summary of loans that are not performing in accordance with their original contractual terms (in thousands):

|                                   | <b>December 31,</b> |               |
|-----------------------------------|---------------------|---------------|
|                                   | <b>2005</b>         | <b>2004</b>   |
| Non-accrual loans <sup>(1)</sup>  | \$ 6,542            | \$ 10,738     |
| Restructured loans <sup>(2)</sup> | 1,081               | 1,305         |
| <br>Total impaired loans          | <br>\$ 7,623        | <br>\$ 12,043 |

<sup>(1)</sup> The total allowance for losses on loans related to these loans was \$2.2 million and \$3.5 million at December 31,

2005 and 2004,  
respectively.

Interest income  
of \$258,000,  
\$659,000 and  
\$1,025,000 was  
recorded during  
the years ended  
December 31,  
2005, 2004 and  
2003,  
respectively, in  
connection with  
such loans. For  
loans on  
non-accrual  
status at year  
end, additional  
gross interest  
income of  
\$693,000,  
\$1,348,000 and  
\$1,487,000  
would have  
been recorded  
during the years  
ended  
December 31,  
2005, 2004 and  
2003,  
respectively, if  
non-accrual and  
restructured  
loans had been  
current in  
accordance with  
their original  
contractual  
terms.

The average  
recorded  
investment in  
impaired loans  
during the years  
ended  
December 31,  
2005, 2004 and  
2003, was  
\$12.3 million,  
\$13.9 million

and  
\$22.3 million,  
respectively .

- (2) Restructured loans occur when Sterling has agreed to compromise the contractual loan terms to provide a reduction in the rate of interest and, in most instances, an extension of payments of principal or interest, or both, because of deterioration in the financial position of the borrower. Restructured loans performing in accordance with their new terms are not included in non-accrual loans unless there is uncertainty as to the ultimate collection of principal or interest.

**Table of Contents**

**Sterling Financial Corporation**  
**Notes to Consolidated Financial Statements**  
**For the Years Ended December 31, 2005, 2004 and 2003**

**6. Office Properties and Equipment:**

The components of office properties and equipment are as follows (in thousands):

|  | <b>December 31,</b> |             | <b>Estimated<br/>Useful<br/>Life</b> |
|--|---------------------|-------------|--------------------------------------|
|  | <b>2005</b>         | <b>2004</b> |                                      |
| Buildings and improvements                           | \$ 57,678           | \$ 55,234   | 20-40<br>years                       |
| Furniture, fixtures, equipment and computer software | 55,002              | 46,753      | 3-10<br>years                        |
| Leasehold improvements                               | 7,716               | 6,371       | 5-20<br>years                        |
| Automobiles  | 178                 | 154         | 3-5 years                            |
|  | 120,574             | 108,512     |                                      |
| Less accumulated depreciation and amortization       | (51,236)            | (43,317)    |                                      |
|  | 69,338              | 65,195      |                                      |
| Land   | 13,094              | 13,207      |                                      |
| Total office properties and equipment                | \$ 82,432           | \$ 78,402   |                                      |

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

Sterling has goodwill and core deposit intangible assets, which were recorded in connection with certain business combinations.

SFAS No. 142 requires Sterling to test its goodwill for impairment at least annually. Sterling tested its goodwill and found no impairment during 2005, 2004 and 2003. Goodwill and acquired intangible assets have been allocated to the Community Banking segment of Sterling.

**F-22**

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**Table of Contents**

**Sterling Financial Corporation**  
**Notes to Consolidated Financial Statements**  
**For the Years Ended December 31, 2005, 2004 and 2003**

**7. Goodwill and Other Intangible Assets, Continued:**

The changes in the carrying value of goodwill for the years ended December 31, 2005 and 2004 are as follows (in thousands):

|                                   | <b>Amount</b> |
|-----------------------------------|---------------|
| Balance as of January 1, 2004     | \$ 45,075     |
| Goodwill acquired during the year | 67,323        |
| Balance as of December 31, 2004   | 112,398       |
| Goodwill added <sup>(1)</sup>     | 309           |
| Balance at December 31, 2005      | \$ 112,707    |

<sup>(1)</sup> During 2005, \$309,000 of contingent consideration was earned related to the acquisition of Peter W. Wong Associates, Inc. ( PWWA ). See Note 25.

The carrying value of core deposit intangibles at December 31, 2005 and 2004 are as follows (in thousands):

|                          | <b>December 31,</b> |             |
|--------------------------|---------------------|-------------|
|                          | <b>2005</b>         | <b>2004</b> |
| Gross carrying value     | \$ 22,332           | \$ 22,332   |
| Accumulated amortization | (4,707)             | (2,484)     |
| Net carrying value       | \$ 17,625           | \$ 19,848   |

The values of the core deposit intangibles are amortized over the estimated useful life of the deposit relationship, which is currently projected to be 10 years. Core deposit intangible amortization expense for each of 2005 and 2004 was \$2.2 million and for 2003 was \$262,000.

Core deposit intangible amortization expense over the next five years is projected as follows (in thousands):

| <b>Year Ending December 31,</b> | <b>Amount</b> |
|---------------------------------|---------------|
| 2006                            | \$2,222       |
| 2007                            | 2,222         |
| 2008                            | 2,222         |
| 2009                            | 2,222         |
| 2010                            | 2,222         |

**F-23**



**Table of Contents**

**Sterling Financial Corporation**  
**Notes to Consolidated Financial Statements**  
**For the Years Ended December 31, 2005, 2004 and 2003**

**8. Deposits:**

The components of deposits and applicable yields are as follows (in thousands):

|   | <b>December 31,</b> |              |
|---|---------------------|--------------|
|   | <b>2005</b>         | <b>2004</b>  |
| Transaction accounts:                     |                     |              |
| Interest-bearing checking, 0.00% to 3.25% | \$ 432,936          | \$ 413,217   |
| Noninterest-bearing checking              | 673,934             | 574,186      |
| Total transaction accounts                | 1,106,870           | 987,403      |
| Savings accounts:                         |                     |              |
| Regular savings, 0.10% to 0.75%           | 187,646             | 203,487      |
| MMDA, 0.00% to 4.41%                      | 1,124,387           | 901,384      |
| Total savings accounts                    | 1,312,033           | 1,104,871    |
| Time deposit accounts:                    |                     |              |
| Up to 1.99%                               | 27,228              | 521,384      |
| 2.00 to 2.99%                             | 199,163             | 641,324      |
| 3.00 to 3.99%                             | 1,018,140           | 268,773      |
| 4.00 to 4.99%                             | 1,050,936           | 164,019      |
| 5.00 to 5.99%                             | 52,754              | 104,092      |
| 6.00 to 6.99%                             | 33,327              | 63,102       |
| 7.00 and over                             | 5,850               | 8,328        |
| Total time deposit accounts               | 2,387,398           | 1,771,022    |
| Total deposits                            | \$ 4,806,301        | \$ 3,863,296 |

The weighted average interest rate of all deposits was 2.60% and 1.71% at December 31, 2005 and 2004, respectively. At December 31, 2005, the scheduled maturities of time deposit accounts are as follows (in thousands):

|                     | <b>Amount</b> | <b>Weighted<br/>Average<br/>Interest<br/>Rate</b> |
|---------------------|---------------|---|
| Due within 1 year   | \$ 1,841,679  | 3.81%   |
| Due in 1 to 2 years | 225,271       | 4.04  |
| Due in 2 to 3 years | 85,573        | 3.69  |
| Due in 3 to 4 years | 81,251        | 4.14  |
| Due in 4 to 5 years | 55,613        | 5.17  |
| Due after 5 years   | 98,011        | 4.86  |





**Table of Contents**

**Sterling Financial Corporation**  
**Notes to Consolidated Financial Statements**  
**For the Years Ended December 31, 2005, 2004 and 2003**

**8. Deposits, Continued:**

At December 31, 2005 and 2004, the remaining maturities of time deposit accounts with a minimum balance of \$100,000 were as follows (in thousands):

|                     | <b>December 31,</b> |                     |
|---------------------|---------------------|---------------------|
|                     | <b>2005</b>         | <b>2004</b>         |
| Less than 3 months  | \$ 525,623          | \$ 293,748          |
| Over 3 to 6 months  | 332,184             | 245,928             |
| Over 6 to 12 months | 449,559             | 202,773             |
| Over 12 months      | 201,183             | 261,189             |
|                     | <b>\$ 1,508,549</b> | <b>\$ 1,003,638</b> |

The components of interest expense associated with deposits are as follows (in thousands):

|                          | <b>Years Ended December 31,</b> |                  |                  |
|--------------------------|---------------------------------|------------------|------------------|
|                          | <b>2005</b>                     | <b>2004</b>      | <b>2003</b>      |
| Transaction accounts     | \$ 1,340                        | \$ 837           | \$ 991           |
| Regular savings accounts | 802                             | 1,242            | 635              |
| MMDA                     | 21,470                          | 10,105           | 5,943            |
| Time deposit accounts    | 68,378                          | 41,299           | 29,262           |
|                          | <b>\$ 91,990</b>                | <b>\$ 53,483</b> | <b>\$ 36,831</b> |

**9. Advances from Federal Home Loan Bank of Seattle:**

Advances from FHLB Seattle are collateralized by certain investments and MBS and qualifying loans with a carrying value of approximately \$1.95 billion and \$2.18 billion at December 31, 2005 and 2004, respectively. Sterling Savings Bank's credit line with FHLB Seattle is limited to a percentage of its total regulatory assets, subject to collateralization requirements. At December 31, 2005, Sterling Savings Bank had the ability to borrow an additional \$278.8 million from FHLB Seattle.

The advances from FHLB Seattle at December 31, 2005 and 2004, are repayable as follows (in thousands):

|                     | <b>December 31, 2005</b> |   | <b>December 31, 2004</b> |   |
|---------------------|--------------------------|---|--------------------------|---|
|                     | <b>Amount</b>            | <b>Weighted<br/>Average<br/>Interest<br/>Rate</b> | <b>Amount</b>            | <b>Weighted<br/>Average<br/>Interest<br/>Rate</b> |
| Due within 1 year   | \$ 670,047               | 3.39%   | \$ 562,238               | 3.36%   |
| Due in 1 to 2 years | 131,018                  | 3.76  | 447,814                  | 2.67  |
| Due in 2 to 3 years | 120,636                  | 4.30  | 141,677                  | 3.73  |
| Due in 3 to 4 years | 168,000                  | 3.81  | 243,270                  | 4.08  |
| Due in 4 to 5 years | 225,000                  | 4.41  | 57,072                   | 5.98  |
| Due after 5 years   | 128,761                  | 4.23  | 183,862                  | 5.34  |
|                     | <b>\$ 1,443,462</b>      |   | <b>\$ 1,635,933</b>      |   |



**Table of Contents****Sterling Financial Corporation****Notes to Consolidated Financial Statements****For the Years Ended December 31, 2005, 2004 and 2003****10. Securities Sold Subject to Repurchase Agreements and Funds Purchased:**

Sterling sells securities under agreements to repurchase the same or similar securities ( reverse repurchase agreements ). Fixed-coupon reverse repurchase agreements are treated as financings, and the obligations to repurchase securities sold are reflected as a liability on the consolidated balance sheet. The dollar amount of securities underlying the agreements remains in the applicable asset accounts. These agreements had a weighted average interest rate of 3.68% and 2.53% at December 31, 2005 and 2004, respectively. At December 31, 2005, substantially all of Sterling s reverse repurchase agreements were transacted with Morgan Stanley (\$167.4 million), Merrill Lynch (\$50.0 million), First Boston (\$150.0 million) and Citigroup (\$191.5 million), with the balance of such short-term repurchase agreements of \$52.8 million, held by various other retail customers. The MBS underlying these agreements is held by Sterling, but the title has been transferred to the aforementioned banks. The risk of default under such agreements is limited by the financial strength of these broker/dealers and the level of borrowings relative to the market value of pledged securities. At December 31, 2005, under the reverse repurchase agreements, Sterling has pledged as collateral investments and MBS with aggregate amortized costs and market values of \$692.0 million and \$669.0 million, respectively. The average balances of reverse repurchase agreements were \$634.8 million, \$630.1 million and \$236.0 million during the years ended December 31, 2005, 2004 and 2003, respectively. The maximum amount outstanding at any month end during these same periods was \$821.4 million, \$779.0 million and \$360.6 million, respectively. At December 31, 2005 and 2004, securities sold subject to repurchase agreements are repayable as follows (in thousands):

|                   | <b>December 31, 2005</b> |   | <b>December 31, 2004</b> |   |
|-------------------|--------------------------|---|--------------------------|---|
|                   | <b>Amount</b>            | <b>Weighted<br/>Average<br/>Interest<br/>Rate</b> | <b>Amount</b>            | <b>Weighted<br/>Average<br/>Interest<br/>Rate</b> |
| Due within 1 year | \$ 261,676               | 4.07%   | \$ 779,012               | 2.53%   |
| Due after 1 year  | 350,000                  | 3.39  | 0                        | 0.00  |
|                   | \$ 611,676               |   | \$ 779,012               |   |

At December 31, 2004, outstanding federal funds purchased were \$1.0 million.

**F-26**

**Table of Contents**

**Sterling Financial Corporation**  
**Notes to Consolidated Financial Statements**  
**For the Years Ended December 31, 2005, 2004 and 2003**

**11. Other Borrowings:**

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

|  | <b>December 31,</b> |                |
|--|---------------------|----------------|
|  | <b>2005</b>         | <b>2004</b>    |
| Term note payable <sup>(1)</sup>           | \$ 0                | \$ 19,000      |
| Trust Preferreds Securities <sup>(2)</sup> | 108,707             | 108,685        |
| Other <sup>(3)</sup>                       | 1,981               | 4,137          |
| <br>Total other borrowings                 | <br>\$ 110,688      | <br>\$ 131,822 |

(1) At December 31, 2004, Sterling had a \$19 million variable-rate term note with U.S. Bank, N.A. ( U.S. Bank ). On March 31, 2005, Sterling repaid \$14 million of principal on this borrowing. On April 29, 2005, Sterling repaid the remaining balance of this borrowing.

On May 18, 2005, Sterling entered into a \$40 million variable-rate credit agreement (the Credit Facility ) with Bank of Scotland. Funds can be borrowed for up to one year after the agreement date

before the credit line expires. Once funds have been borrowed, Sterling can take up to seven years to repay the principal. Amounts loaned pursuant to the Credit Facility bear Eurodollar interest at the LIBOR rate (as defined in the Credit Facility) plus a specified margin based on Sterling's credit ratings and compliance with the terms of the Credit Facility. The Credit Facility is secured by a majority of the preferred stock of Sterling's wholly owned subsidiary, Sterling Savings Bank. The Credit Facility contains representations and warranties, and negative and affirmative covenants by Sterling, including financial covenants and restrictions on Sterling's ability to take certain actions, such as incur debt, make investments and

make acquisitions of other entities. Sterling is obligated to commence repayment of any loan principal on the third anniversary of the date Sterling entered into the Credit Facility, and is permitted to prepay loan principal without penalty. No amounts borrowed and repaid under the Credit Facility may be reborrowed. As of December 31, 2005, no funds had been advanced to Sterling under the Credit Facility.

**F-27**

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**Table of Contents****Sterling Financial Corporation****Notes to Consolidated Financial Statements****For the Years Ended December 31, 2005, 2004 and 2003****11. Other Borrowings, Continued:**

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

Details of the Trust Preferred Securities are as follows:

| <b>Subsidiary Issuer</b>           | <b>Issue Date</b> | <b>Maturity Date</b> | <b>Call Date</b> | <b>Mandatorily Redeemable Capital Security</b> | <b>Rate at December 31, 2005</b> | <b>Amount (in Thousands)</b> |
|------------------------------------|-------------------|----------------------|------------------|--|----------------------------------|------------------------------|
| Sterling Capital Trust VI          | June 2003         | Sept 2033            | Sept 2008        | Floating Rate Capital Securities               | 7.69%                            | \$ 10,310                    |
| Sterling Capital Statutory Trust V | May 2003          | May 2033             | June 2008        | Floating Rate Capital Securities               | 7.77%                            | 20,619                       |
| Sterling Capital Trust IV          | May 2003          | May 2033             | May 2008         | Floating Rate Preferred Securities             | 7.49%                            | 10,310                       |
| Sterling Capital Trust III         | April 2003        | April 2033           | April 2008       | Floating Rate Capital Securities               | 7.50%                            | 14,433                       |
| Klamath First Capital Trust II     | April 2002        | April 2032           | April 2007       | Floating Rate Capital Securities               | 8.15%                            | 13,144                       |
| Klamath First Capital Trust I      | July 2001         | July 2031            | June 2006        | Floating Rate Capital Securities               | 7.67%                            | 15,148                       |
| Sterling Capital Trust II          | July 2001         | July 2031            | June 2006        | 10.25% Cumulative Capital Securities           | 10.25%                           | 24,743                       |
|                                    |                   |                      |                  |  | 8.30%*                           | \$ 108,707                   |

\* Weighted average rate

(3) During 2002, Sterling financed the



sale of certain loans to an unrelated party. Since the underlying loans served as collateral on the loan to the purchaser, this sale was accounted for as a financing. At December 31, 2005 and 2004, \$2.0 million and \$4.1 million remained outstanding on the financing, respectively.

**F-28**

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**Table of Contents**

**Sterling Financial Corporation**  
**Notes to Consolidated Financial Statements**  
**For the Years Ended December 31, 2005, 2004 and 2003**

**12. Income Taxes:**

The components of income tax expense (benefit) included in the consolidated statements of income were as follows (in thousands):

|                             | <b>Years Ended December 31,</b> |             |             |
|-----------------------------|---------------------------------|-------------|-------------|
|                             | <b>2005</b>                     | <b>2004</b> | <b>2003</b> |
| Current income taxes:       |                                 |             |             |
| Federal                     | \$ 21,667                       | \$ 17,229   | \$ 24,107   |
| State                       | 1,525                           | 1,801       | 1,451       |
| Total current income taxes  | 23,192                          | 19,030      | 25,558      |
| Deferred income taxes:      |                                 |             |             |
| Federal                     | 5,703                           | 8,031       | (6,501)     |
| State                       | 509                             | 729         | (379)       |
| Total deferred income taxes | 6,212                           | 8,760       | (6,880)     |
| Total income tax expense    | \$ 29,404                       | \$ 27,790   | \$ 18,678   |

The tax effects of the principal temporary differences giving rise to deferred tax assets and liabilities were as follows (in thousands):

|  | <b>December 31,</b> |                    |               |                    |
|--|---------------------|--------------------|---------------|--------------------|
|  | <b>2005</b>         |                    | <b>2004</b>   |                    |
|  | <b>Assets</b>       | <b>Liabilities</b> | <b>Assets</b> | <b>Liabilities</b> |
| Allowance for losses on loans                      | \$ 20,057           | \$ 0               | \$ 18,410     | \$ 0               |
| Unrealized losses on available-for-sale securities | 20,025              | 0                  | 5,467         | 0                  |
| Investment securities basis difference             | 12,314              | 12,941             | 20,971        | 12,678             |
| Deferred compensation                              | 4,775               | 0                  | 3,795         | 0                  |
| FHLB Seattle dividends                             | 0                   | 12,930             | 0             | 13,174             |
| Deferred loan fees                                 | 0                   | 3,280              | 0             | 3,369              |
| Office properties and equipment                    | 0                   | 2,417              | 0             | 2,245              |
| Mortgage servicing rights                          | 0                   | 1,801              | 0             | 1,267              |
| Nonaccrual loans                                   | 527                 | 0                  | 508           | 0                  |
| Prepaid expenses                                   | 0                   | 570                | 0             | 633                |
| Other  | 0                   | 0                  | 0             | 372                |
|  | \$ 57,698           | \$ 33,939          | \$ 49,151     | \$ 33,738          |

**F-29**

**Table of Contents**

**Sterling Financial Corporation**  
**Notes to Consolidated Financial Statements**  
**For the Years Ended December 31, 2005, 2004 and 2003**

**12. Income Taxes, Continued:**

A valuation allowance against deferred tax assets has not been established as it is more likely than not that these assets will be realized. The following table summarizes the calculation of Sterling's effective tax rates for the periods presented (in thousands):

|  | Years Ended December 31, |       |           |       |           |       |
|--|--------------------------|-------|-----------|-------|-----------|-------|
|  | 2005                     |       | 2004      |       | 2003      |       |
|  | Amount                   | %     | Amount    | %     | Amount    | %     |
| Income tax provision at the federal statutory rate | \$ 31,718                | 35.0% | \$ 29,433 | 35.0% | \$ 18,757 | 35.0% |
| Tax effect of:                                     |                          |       |           |       |           |       |
| State taxes, net of federal benefit                | 1,322                    | 1.5   | 1,644     | 2.0   | 697       | 1.3   |
| Tax-exempt interest                                | (655)                    | (0.7) | (770)     | (0.9) | (171)     | (0.3) |
| Bank owned life insurance                          | (2,070)                  | (2.3) | (1,519)   | (1.8) | (1,310)   | (2.4) |
| Acquisition costs                                  | 0                        | 0.0   | (366)     | (0.4) | (236)     | (0.4) |
| Tax credits  | (874)                    | (1.0) | (531)     | (0.6) | 0         | 0.0   |
| Other, net   | (37)                     | (0.1) | (101)     | (0.1) | 941       | 1.7   |
|  | \$ 29,404                | 32.4% | \$ 27,790 | 33.2% | \$ 18,678 | 34.9% |

**F-30**

**Table of Contents**

**Sterling Financial Corporation**  
**Notes to Consolidated Financial Statements**  
**For the Years Ended December 31, 2005, 2004 and 2003**

**13. Stock Options:**

Sterling has granted options to purchase shares of its common stock at exercise prices equal to the fair market value of the stock at the date of grant. The vesting of options ranges from immediately upon grant to four years and their exercisability ranges from immediately upon grant to ten years from the date of grant. Sterling is authorized to grant options to purchase up to 2.3 million shares under various stock option incentive plans. At December 31, 2005, options to purchase up to 456,249 shares remained available for grant.

Stock option transactions are summarized as follows:

|                                | Number of | Weighted | Exercise Price Per |          |
|--------------------------------|-----------|----------|--------------------|----------|
|                                | Shares    | Average  | Share              |          |
|                                |           | Exercise |                    |          |
|                                |           | Price    |                    |          |
| Balance, January 1, 2003       | 1,486,964 | \$ 5.54  | \$ 3.66            | \$ 10.29 |
| Options granted                | 349,500   | 19.30    | \$ 17.13           | \$ 19.84 |
| Options exercised              | (276,000) | 5.25     | \$ 3.66            | \$ 8.39  |
| Balance, December 31, 2003     | 1,560,464 | 9.61     | \$ 3.92            | \$ 8.39  |
| Options granted                | 478,500   | 26.49    | \$ 20.55           | \$ 26.71 |
| Options issued in merger       | 650,298   | 10.38    | \$ 10.18           | \$ 16.03 |
| Options exercised              | (895,287) | 8.09     | \$ 3.92            | \$ 16.03 |
| Balance, December 31, 2004     | 1,793,975 | 15.18    | \$ 4.27            | \$ 26.71 |
| Options granted                | 401,000   | 25.71    | \$ 25.71           | \$ 25.71 |
| Options exercised              | (491,016) | 8.93     | \$ 4.27            | \$ 19.84 |
| Balance, December 31, 2005     | 1,703,959 | \$ 19.46 | \$ 4.27            | \$ 26.71 |
| Vested options                 | 1,700,659 | 19.48    |                    |          |
| Unvested options               | 3,300     | 10.15    |                    |          |
| Balance, December 31, 2005     | 1,703,959 | \$ 19.46 |                    |          |
| Exercisable, December 31, 2005 | 1,700,659 | \$ 19.48 |                    |          |

The weighted average fair value of options granted during the years ended December 31, 2005, 2004 and 2003, was \$7.91, \$11.77 and \$17.53, respectively.

**F-31**

**Table of Contents**

**Sterling Financial Corporation**  
**Notes to Consolidated Financial Statements**  
**For the Years Ended December 31, 2005, 2004 and 2003**

**13. Stock Options, Continued:**

The following table summarizes information about Sterling's plans at December 31, 2005:

| Range of Exercise | Options Outstanding |   |  | Options Exercisable |  |
|-------------------|---------------------|---|--|---------------------|--|
|                   | Number              | Weighted<br>Average<br>Remaining<br>Contractual<br>Life | Weighted<br>Average<br>Exercise<br>Price | Number              | Weighted<br>Average<br>Exercise<br>Price |
| <b>Prices</b>     | <b>Outstanding</b>  | <b>Life</b>   | <b>Price</b>                             | <b>Exercisable</b>  | <b>Price</b>                             |
| \$ 4.27 - \$ 8.01 | 226,834             | 3.3 years   | \$ 5.76                                  | 226,834             | \$ 5.76                                  |
| \$ 8.01 - \$12.02 | 273,001             | 4.6 years   | 10.05                                    | 269,701             | 10.05                                    |
| \$12.02 - \$16.03 | 26,846              | 7.1 years   | 13.13                                    | 26,846              | 13.13                                    |
| \$16.03 - \$20.04 | 297,778             | 5.7 years   | 19.38                                    | 297,778             | 19.38                                    |
| \$20.04 - \$24.01 | 22,500              | 7.0 years   | 21.82                                    | 22,500              | 21.82                                    |
| \$24.01 - \$26.71 | 857,000             | 6.6 years   | 26.24                                    | 857,000             | 26.24                                    |
|                   | 1,703,959           |   |  | 1,700,659           |  |

All share and dollar amounts have been restated to reflect the conversion of options upon the consummation of business combinations into a Sterling stock option at the exchange ratio. All exercise prices have been restated to reflect all common stock dividends paid to date.

**14. Shareholders' Equity:**

On January 2, 2004, Sterling issued 5,431,067 shares of common stock (net of 194 fractional shares) in its acquisition of Klamath First Bancorp, Inc. (KFBI). On November 30, 2004, Sterling issued 24,008 shares of common stock in connection with INTERVEST's acquisition of PWWA. See Note 25.

In October 2005, Sterling paid a \$0.05 per share, or \$1.7 million of cash dividends to shareholders of record as of September 30, 2005. In January 2006, Sterling paid a \$0.055 per share, or \$1.9 million of cash dividends to shareholders of record as of December 30, 2005. The January 2006 cash dividend was accrued as of the record date.

On August 31, 2005, Sterling completed a three for two stock split, resulting in the issuance of 11,553,249 shares of common stock to shareholders of record as of August 17, 2005. This split was effected in the form of a 50% stock dividend. During 2004 and 2003, Sterling issued 10% stock dividends. All weighted average shares outstanding and per share amounts have been retroactively restated to reflect these transactions.

In December 2005, Sterling registered one million shares of its common stock to be periodically issued pursuant to Sterling's Dividend Reinvestment and Direct Stock Purchase and Sale Plan, including discounts ranging from 0% to 5%, at Sterling's discretion.

The Board has the authority to issue preferred stock of Sterling in one or more series and to fix the rights, privileges, preferences and restrictions granted to or imposed upon any unissued shares of preferred stock, without further vote or action by the common shareholders.

**15. Earnings Per Share:**

The following table (dollars in thousands, except per share amounts) presents a reconciliation of the numerators and denominators used in the basic and diluted earnings per share computations, which includes the number of antidilutive securities that were not included in the dilutive earnings per share computations. These antidilutive securities occur when options outstanding held an option price greater than the average market price for the period. All prior period per share amounts have been restated to reflect the three for two stock split in August 2005.

F-32



**Table of Contents**

**Sterling Financial Corporation**  
**Notes to Consolidated Financial Statements**  
**For the Years Ended December 31, 2005, 2004 and 2003**

**15. Earnings Per Share, Continued:**

|   |         | <b>For the Year Ended December 31, 2005</b> |                      |               |
|---|---------|---|----------------------|---------------|
|   |         | <b>Net</b>                                  | <b>Weighted</b>      | <b>Per</b>    |
|   |         | <b>Income</b>                               | <b>Average</b>       | <b>Share</b>  |
|   |         | <b>(Numerator)</b>                          | <b>Shares</b>        | <b>Amount</b> |
|   |         |   | <b>(Denominator)</b> |               |
| Earnings per common share                                       | basic   | \$ 61,219                                   | 34,633,952           | \$ 1.77       |
| Effect of dilutive securities:                                  |         |   |                      |               |
| Common stock options  |         | 0   | 365,065              | (0.02)        |
| Contingently issuable shares                                    |         | 0   | 36,012               | 0.00          |
| Earnings per common share                                       | diluted | \$ 61,219                                   | 35,035,029           | \$ 1.75       |
| Antidilutive options not included in diluted earnings per share |         |   | 857,000              |               |

|   |         | <b>For the Year Ended December 31, 2004</b> |                      |               |
|---|---------|---|----------------------|---------------|
|   |         | <b>Net</b>                                  | <b>Weighted</b>      | <b>Per</b>    |
|   |         | <b>Income</b>                               | <b>Average</b>       | <b>Share</b>  |
|   |         | <b>(Numerator)</b>                          | <b>Shares</b>        | <b>Amount</b> |
|   |         |   | <b>(Denominator)</b> |               |
| Earnings per common share                                       | basic   | \$ 56,305                                   | 33,931,509           | \$ 1.66       |
| Effect of dilutive securities:                                  |         |   |                      |               |
| Common stock options  |         | 0   | 774,236              | (0.04)        |
| Contingently issuable shares                                    |         | 0   | 3,049                | 0.00          |
| Earnings per common share                                       | diluted | \$ 56,305                                   | 34,708,794           | \$ 1.62       |
| Antidilutive options not included in diluted earnings per share |         |   | 469,500              |               |

|   |         | <b>For the Year Ended December 31, 2003</b> |                      |               |
|---|---------|---|----------------------|---------------|
|   |         | <b>Net</b>                                  | <b>Weighted</b>      | <b>Per</b>    |
|   |         | <b>Income</b>                               | <b>Average</b>       | <b>Share</b>  |
|   |         | <b>(Numerator)</b>                          | <b>Shares</b>        | <b>Amount</b> |
|   |         |   | <b>(Denominator)</b> |               |
| Earnings per common share                                       | basic   | \$ 34,913                                   | 23,980,113           | \$ 1.45       |
| Effect of dilutive securities:                                  |         |   |                      |               |
| Common stock options  |         | 0   | 610,059              | (0.03)        |
| Earnings per common share                                       | diluted | \$ 34,913                                   | 24,590,172           | \$ 1.42       |
| Antidilutive options not included in diluted earnings per share |         |   | 0                    |               |





**Table of Contents****Sterling Financial Corporation****Notes to Consolidated Financial Statements****For the Years Ended December 31, 2005, 2004 and 2003****16. Regulatory Capital:**

Sterling and Sterling Savings Bank are required by applicable regulations to maintain certain minimum capital levels. Sterling and Sterling Savings Bank intend to enhance their capital resources and regulatory capital ratios 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 December 31, 2005, Sterling and Sterling Savings Bank both exceeded all such regulatory capital requirements and were well capitalized pursuant to such regulations.

The following table sets forth the amounts and ratios regarding actual and minimum core (Tier I) risk-based and total risk-based capital requirements, together with the amounts and ratios required to meet the definition of a well-capitalized institution, without giving effect to forbearance or capital provisions contained in certain merger and acquisition agreements (dollars in thousands).

|  | Minimum Capital Requirements |       | Well-Capitalized Requirements |       | Actual     |       |
|--|------------------------------|-------|-------------------------------|-------|------------|-------|
|  | Amount                       | Ratio | Amount                        | Ratio | Amount     | Ratio |
| As of December 31, 2005:               |                              |       |                               |       |            |       |
| Total capital to risk-weighted assets  |                              |       |                               |       |            |       |
| Sterling                               | \$ 442,969                   | 8.0%  | \$ 553,712                    | 10.0% | \$ 580,191 | 10.5% |
| Sterling Savings Bank                  | 442,495                      | 8.0   | 553,119                       | 10.0  | 563,194    | 10.2  |
| Tier I capital to risk-weighted assets |                              |       |                               |       |            |       |
| Sterling                               | 221,485                      | 4.0   | 332,227                       | 6.0   | 524,708    | 9.5   |
| Sterling Savings Bank                  | 221,248                      | 4.0   | 331,871                       | 6.0   | 507,711    | 9.2   |
| Tier I capital to average assets       |                              |       |                               |       |            |       |
| Sterling                               | 283,237                      | 4.0   | 354,046                       | 5.0   | 524,708    | 7.4   |
| Sterling Savings Bank                  | 283,573                      | 4.0   | 354,466                       | 5.0   | 507,711    | 7.2   |
| As of December 31, 2004 <sup>(1)</sup> |                              |       |                               |       |            |       |
| :                                      |                              |       |                               |       |            |       |
| Total capital to risk-weighted assets  |                              |       |                               |       |            |       |
| Sterling Savings Bank                  | 370,807                      | 8.0   | 463,509                       | 10.0  | 496,752    | 10.7  |
| Tier I capital to risk-weighted assets |                              |       |                               |       |            |       |
| Sterling Savings Bank                  | 185,404                      | 4.0   | 278,105                       | 6.0   | 450,918    | 9.7   |
| Tier I capital to average assets       |                              |       |                               |       |            |       |
| Sterling Savings Bank                  | 272,599                      | 4.0   | 340,748                       | 5.0   | 450,918    | 6.6   |

(1) Sterling Financial Corporation did not have regulatory capital ratio

requirements  
prior to its  
conversion to a  
bank holding  
company in July  
of 2005.

**F-34**

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**Table of Contents**

**Sterling Financial Corporation**  
**Notes to Consolidated Financial Statements**  
**For the Years Ended December 31, 2005, 2004 and 2003**

**17. Commitments and Contingencies:**

Sterling is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to originate and purchase loans, provide funds under existing lines of credit, and include forward loan sale agreements to mortgage brokers. Commitments, which are disbursed subject to certain limitations, extend over various periods of time, with the majority of funds being disbursed within a twelve-month period. Substantially all of the commitments are for loans that have credit risk similar to Sterling's existing portfolio. Secured and unsecured lines of credit provide for periodic adjustment to market rates of interest and have credit risk similar to Sterling's existing portfolio.

The undisbursed balances and other commitments as of the dates indicated are summarized as follows (in thousands):

|  | <b>December 31,</b> |             |
|--|---------------------|-------------|
|  | <b>2005</b>         | <b>2004</b> |
| Undisbursed loan funds - construction loans    | \$ 911,864          | \$ 423,250  |
| Undisbursed lines of credit - commercial loans | 579,182             | 497,911     |
| Undisbursed lines of credit - consumer loans   | 247,030             | 187,292     |
| Firm commitments to purchase loans             | 13,911              | 61,983      |
| Firm commitments to sell loans                 | 22,408              | 16,965      |

As of December 31, 2005 and 2004, Sterling had approximately \$37.5 million and \$26.5 million of commercial and standby letters of credit outstanding, respectively. During the years ended December 31, 2005 and 2004, Sterling collected approximately \$240,000 and \$114,000 in fees from these off-balance sheet arrangements.

Sterling historically has not realized material credit losses due to these off-balance sheet credits. Based on this fact and Sterling's analysis of the undisbursed portion of these lines of credit, no specific valuation allowances were recorded for these off-balance sheet credits at December 31, 2005 and 2004.

As of December 31, 2005, Sterling had committed to invest a total of \$17.0 million in a limited partnership for the development of low-income housing. As of December 31, 2005, \$1.6 million of this commitment was disbursed. The fund invests in a series of low-income projects throughout the Pacific Northwest. Sterling receives tax deductions and tax credits from the partnership, which Sterling anticipates will yield a positive return on investment, but anticipates that the partnership interest will have no value at the end of the fifteen-year term.

Future minimum rental commitments as of December 31, 2005, under non-cancelable operating leases with initial or remaining terms of more than one year, are as follows (in thousands):

| <b>Year Ending December 31,</b> | <b>Amount</b>    |
|---------------------------------|------------------|
| 2006                            | \$ 6,857         |
| 2007                            | 6,394            |
| 2008                            | 5,798            |
| 2009                            | 4,833            |
| 2010                            | 3,692            |
| Thereafter                      | 17,311           |
|                                 | <b>\$ 44,885</b> |

Rent expense recorded for the years ended December 31, 2005, 2004 and 2003 was \$5.9 million, \$4.5 million and \$2.9 million, respectively.

**F-35**

**Table of Contents**

**Sterling Financial Corporation**  
**Notes to Consolidated Financial Statements**  
**For the Years Ended December 31, 2005, 2004 and 2003**

**18. Benefit Plans:**

Sterling maintains an employee savings plan under Section 401(k) of the Internal Revenue Code. Substantially all employees are eligible to participate in the plan subject to certain requirements. Under the plan, employees may elect to contribute up to 10% of their salary, and Sterling will make a matching contribution equal to 35% of the employee's contribution. All matching contributions are made exclusively in the form of Sterling common stock. Each employee may make a supplemental contribution of an additional 65% of their salary. All employee contributions vest immediately and, if applicable, employer contributions vest over the employee's first three years of employment. Employees have the option of investing their contributions among selected mutual funds and Sterling common stock. During the years ended December 31, 2005, 2004 and 2003, Sterling contributed approximately \$1.4 million, \$1.3 million and \$882,000, respectively, to the employee savings plan.

Since 1984, Sterling has maintained a nonqualified Deferred Compensation Plan. The Deferred Compensation Plan component of the overall compensation plan is intended to link compensation to the long-term performance of Sterling and to provide a strong incentive for increasing shareholder value. As of December 31, 2005, there were seven participants in the Deferred Compensation Plan. The Deferred Compensation Plan was replaced with a Supplemental Executive Retirement Plan in 2002, and the Board has decided not to make any further contributions to the Deferred Compensation Plan. All amounts in a participant's account become 100% vested upon a change of control; when the participant attains normal retirement age; when the employment of the participant terminates due to death or disability; or upon termination of the Plan. Prior to such an event, amounts in a participant's account vest at the rate of 10% per year of service, provided that such vesting shall reach 100% when the participant reaches the age of 60. Payment of an account may be in a lump sum or in installments as determined by the Board, and installments may be accelerated by the Board. Payment must be commenced within one year of the termination of the participant's employment with Sterling. Sterling had \$80,000, \$129,000 and \$181,000 in expense related to this plan for the years ending December 31, 2005, 2004 and 2003, respectively.

Since 2002, Sterling has maintained a Supplemental Executive Retirement Plan (the SERP). The SERP is a nonqualified, unfunded plan that is designed to provide retirement benefits for certain key employees of Sterling. Depending on their classification under the Plan, for 10 to 15 years, beginning at normal retirement age, participants will receive from 40%-60% of their base salary amount as of January 1, 2002. Retirement benefits vest at the rate of 10% per year of service. Except for participants who have completed 25 years of service, benefits are reduced for early retirement. Retirement benefits become 100% vested if, within two years of a change of control of Sterling Savings Bank, either the Plan or the participant's employment are terminated. Sterling maintains and administers three additional SERPs from past acquisitions. These SERPs are all nonqualified, unfunded plans that were designed to provide retirement benefits for certain key employees and directors of the acquired companies. All amounts and benefits were established and accrued at acquisition either by previous service or change of control clauses. Sterling continues to administer these benefit plans, as necessary. Sterling had \$1.8 million, \$1.6 million and \$724,000 in expense related to these plans for the years ended December 31, 2005, 2004 and 2003, respectively.

**F-36**

**Table of Contents**

**Sterling Financial Corporation**  
**Notes to Consolidated Financial Statements**  
**For the Years Ended December 31, 2005, 2004 and 2003**

**19. Non-Interest Expenses:**

The components of total non-interest expenses are as follows (in thousands):

|  | <b>Years Ended December 31,</b> |                   |                  |
|--|---------------------------------|-------------------|------------------|
|  | <b>2005</b>                     | <b>2004</b>       | <b>2003</b>      |
| Employee compensation and benefits       | \$ 93,367                       | \$ 77,617         | \$ 51,066        |
| Occupancy and equipment                  | 26,411                          | 23,051            | 14,687           |
| Amortization of core deposit intangibles | 2,222                           | 2,222             | 262              |
| Data processing                          | 12,678                          | 10,596            | 6,786            |
| Depreciation                             | 8,627                           | 7,321             | 4,994            |
| Advertising                              | 9,125                           | 6,976             | 5,316            |
| Travel and entertainment                 | 4,522                           | 4,071             | 2,711            |
| Legal and accounting                     | 3,134                           | 3,075             | 2,206            |
| Insurance                                | 1,213                           | 1,155             | 750              |
| Goodwill litigation                      | 179                             | 141               | 600              |
| Merger and acquisition costs             | 0                               | 4,835             | 792              |
| Other                                    | 8,803                           | 7,310             | 4,394            |
|  | <b>\$ 170,281</b>               | <b>\$ 148,370</b> | <b>\$ 94,564</b> |

**20. Segment Information:**

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

The Community Banking segment consists of the operations conducted by Sterling's subsidiary, Sterling Savings Bank.

The Residential Mortgage Banking segment originates and sells servicing-retained and servicing-released residential loans through loan production offices in Washington, Oregon, Idaho, Montana and Utah, primarily through 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 Oregon, Washington, Arizona and California primarily through INTERVEST.

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

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

**F-37**

**Table of Contents****Sterling Financial Corporation****Notes to Consolidated Financial Statements****For the Years Ended December 31, 2005, 2004 and 2003****20. Segment Information, Continued:**

The following table presents certain financial information regarding Sterling's segments and provides a reconciliation to Sterling's consolidated totals as of and for the years ended December 31, 2005, 2004 and 2003 (in thousands):

|                                      | <b>As of and for the Year Ended December 31, 2005</b> |   |  |                             |                                   |              |
|--------------------------------------|---|---|--|-----------------------------|-----------------------------------|--------------|
|                                      | <b>Community<br/>Banking</b>                          | <b>Residential<br/>Mortgage<br/>Banking</b> | <b>Commercial<br/>Mortgage<br/>Banking</b> | <b>Retail<br/>Brokerage</b> | <b>Other and<br/>Eliminations</b> | <b>Total</b> |
| Interest income                      | \$ 367,918  | \$ 11,794                                   | \$ 8,099                                   | \$ 0                        | \$ 0                              | \$ 387,811   |
| Interest expense                     | (163,405)   | 0   | 0  | 0                           | (7,871)                           | (171,276)    |
| Net interest income<br>(expense)     | 204,513   | 11,794                                      | 8,099                                      | 0                           | (7,871)                           | 216,535      |
| Provision for losses on<br>loans     | (15,200)  | 0   | 0  | 0                           | 0                                 | (15,200)     |
| Noninterest income                   | 52,766  | 9,939                                       | 5,194                                      | 3,516                       | (11,846)                          | 59,569       |
| Noninterest expense                  | (140,153)   | (18,317)                                    | (7,584)                                    | (3,612)                     | (615)                             | (170,281)    |
| Income (loss) before<br>income taxes | \$ 101,926  | \$ 3,416                                    | \$ 5,709                                   | \$ (96)                     | \$ (20,332)                       | \$ 90,623    |
| Total assets                         | \$ 7,627,471  | \$ 22,204                                   | \$ 22,368                                  | \$ 623                      | \$ (113,738)                      | \$ 7,558,928 |

|                                      | <b>As of and for the Year Ended December 31, 2004</b> |   |  |                             |                                   |              |
|--------------------------------------|---|---|--|-----------------------------|-----------------------------------|--------------|
|                                      | <b>Community<br/>Banking</b>                          | <b>Residential<br/>Mortgage<br/>Banking</b> | <b>Commercial<br/>Mortgage<br/>Banking</b> | <b>Retail<br/>Brokerage</b> | <b>Other and<br/>Eliminations</b> | <b>Total</b> |
| Interest income                      | \$ 303,431  | \$ 8,912                                    | \$ 7,280                                   | \$ 1                        | \$ 137                            | \$ 319,761   |
| Interest expense                     | (114,803)   | 0   | 0  | 0                           | (8,142)                           | (122,945)    |
| Net interest income<br>(expense)     | 188,628   | 8,912                                       | 7,280                                      | 1                           | (8,005)                           | 196,816      |
| Provision for losses on<br>loans     | (12,150)  | 0   | 0  | 0                           | 0                                 | (12,150)     |
| Noninterest income                   | 47,073  | 9,202                                       | 1,606                                      | 3,678                       | (13,760)                          | 47,799       |
| Noninterest expense                  | (128,436)   | (14,309)                                    | (3,964)                                    | (2,957)                     | 1,296                             | (148,370)    |
| Income (loss) before<br>income taxes | \$ 95,115   | \$ 3,805                                    | \$ 4,922                                   | \$ 722                      | \$ (20,469)                       | \$ 84,095    |
| Total assets                         | \$ 6,992,194  | \$ 21,212                                   | \$ 18,485                                  | \$ 1,395                    | \$ (91,062)                       | \$ 6,942,224 |

|  | <b>As of and for the Year Ended December 31, 2003</b> |   |  |                             |                                   |
|--|---|---|--|-----------------------------|-----------------------------------|
|  | <b>Community<br/>Banking</b>                          | <b>Residential<br/>Mortgage<br/>Banking</b> | <b>Commercial<br/>Mortgage<br/>Banking</b> | <b>Retail<br/>Brokerage</b> | <b>Other and<br/>Eliminations</b> |

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|                                      | <b>Banking</b> | <b>Banking</b> | <b>Banking</b> | <b>Brokerage</b> | <b>Eliminations</b> | <b>Total</b> |
|--------------------------------------|----------------|----------------|----------------|------------------|---------------------|--------------|
| Interest income                      | \$ 199,799     | \$ 9,054       | \$ 5,871       | \$ 3             | \$ 0                | \$ 214,727   |
| Interest expense                     | (82,423)       | 0              | 0              | 0                | (7,384)             | (89,807)     |
| Net interest income<br>(expense)     | 117,376        | 9,054          | 5,871          | 3                | (7,384)             | 124,920      |
| Provision for losses on<br>loans     | (10,500)       | 0              | 0              | 0                | 0                   | (10,500)     |
| Noninterest income                   | 37,923         | 9,816          | 1,326          | 2,070            | (17,400)            | 33,735       |
| Noninterest expense                  | (80,614)       | (10,638)       | (2,892)        | (1,564)          | 1,144               | (94,564)     |
| Income (loss) before<br>income taxes | \$ 64,185      | \$ 8,232       | \$ 4,305       | \$ 509           | \$ (23,640)         | \$ 53,591    |
| Total assets                         | \$ 4,323,170   | \$ 22,734      | \$ 15,779      | \$ 1,909         | \$ (84,271)         | \$ 4,279,321 |

**F-38**

**Table of Contents**

**Sterling Financial Corporation**  
**Notes to Consolidated Financial Statements**  
**For the Years Ended December 31, 2005, 2004 and 2003**

**21. Quarterly Financial Data (Unaudited):**

The following tables present Sterling's condensed operations on a quarterly basis for the years ended December 31, 2005 and 2004 (in thousands, except per share amounts):

|   | <b>Year Ended December 31, 2005</b> |                           |                          |                           |
|---|-------------------------------------|---------------------------|--------------------------|---------------------------|
|   | <b>First<br/>Quarter</b>            | <b>Second<br/>Quarter</b> | <b>Third<br/>Quarter</b> | <b>Fourth<br/>Quarter</b> |
| Interest income   | \$ 92,066                           | \$ 95,056                 | \$ 94,774                | \$ 105,915                |
| Interest expense  | (39,248)                            | (41,242)                  | (41,686)                 | (49,100)                  |
| Provision for losses on loans                           | (3,750)                             | (3,400)                   | (3,400)                  | (4,650)                   |
| Net interest income after provision for losses on loans | 49,068                              | 50,414                    | 49,688                   | 52,165                    |
| Other income  | 14,639                              | 15,405                    | 13,306                   | 16,219                    |
| Operating expenses                                      | (39,647)                            | (41,602)                  | (42,599)                 | (46,433)                  |
| Income before income taxes                              | 24,060                              | 24,217                    | 20,395                   | 21,951                    |
| Income tax provision                                    | (8,169)                             | (8,209)                   | (6,505)                  | (6,521)                   |
| Net income  | \$ 15,891                           | \$ 16,008                 | \$ 13,890                | \$ 15,430                 |
| Earnings per share basic                                | \$ 0.46                             | \$ 0.46                   | \$ 0.40                  | \$ 0.44                   |
| Earnings per share diluted                              | \$ 0.45                             | \$ 0.46                   | \$ 0.40                  | \$ 0.44                   |
| Weighted average shares outstanding basic               | 34,484,822                          | 34,597,964                | 34,660,107               | 34,789,284                |
| Weighted average shares outstanding diluted             | 34,979,051                          | 35,022,597                | 35,097,474               | 35,121,020                |

|   | <b>Year Ended December 31, 2004</b> |                           |                          |                           |
|---|-------------------------------------|---------------------------|--------------------------|---------------------------|
|   | <b>First<br/>Quarter</b>            | <b>Second<br/>Quarter</b> | <b>Third<br/>Quarter</b> | <b>Fourth<br/>Quarter</b> |
| Interest income   | \$ 73,391                           | \$ 77,240                 | \$ 81,626                | \$ 87,504                 |
| Interest expense  | (27,702)                            | (28,516)                  | (31,425)                 | (35,302)                  |
| Provision for losses on loans                           | (2,850)                             | (3,000)                   | (3,000)                  | (3,300)                   |
| Net interest income after provision for losses on loans | 42,839                              | 45,724                    | 47,201                   | 48,902                    |



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|   |            |            |            |            |
|---|------------|------------|------------|------------|
| Net gain on sales of securities             | 2,459      | 848        | 1,264      | 0          |
| Other income                                | 10,439     | 10,961     | 11,403     | 10,425     |
| Operating expenses                          | (37,719)   | (37,088)   | (36,570)   | (36,993)   |
| Income before income taxes                  | 18,018     | 20,445     | 23,298     | 22,334     |
| Income tax provision                        | (6,034)    | (6,962)    | (7,988)    | (6,806)    |
| Net income                                  | \$ 11,984  | \$ 13,483  | \$ 15,310  | \$ 15,528  |
| Earnings per share basic                    | \$ 0.36    | \$ 0.40    | \$ 0.45    | \$ 0.45    |
| Earnings per share diluted                  | \$ 0.35    | \$ 0.39    | \$ 0.44    | \$ 0.44    |
| Weighted average shares outstanding basic   | 33,532,197 | 33,883,664 | 34,015,769 | 34,290,222 |
| Weighted average shares outstanding diluted | 34,429,134 | 34,650,080 | 34,721,952 | 34,948,536 |

**F-39**

**Table of Contents**

**Sterling Financial Corporation**

**Notes to Consolidated Financial Statements**

**For the Years Ended December 31, 2005, 2004 and 2003**

**22. Fair Values of Financial Instruments:**

Fair value estimates are determined as of a specific date in time utilizing quoted market prices, where available, or various assumptions and estimates. As the assumptions underlying these estimates change, the fair value of the financial instruments will change. The use of assumptions and various valuation techniques, as well as the absence of secondary markets for certain financial instruments, will likely reduce the comparability of fair value disclosures between financial institutions. Accordingly, the aggregate fair value amounts presented do not represent and should not be construed to represent the full underlying value of Sterling.

The methods and assumptions used to estimate the fair values of each class of financial instruments are as follows:

**Cash and Cash Equivalents**

The carrying value of cash and cash equivalents approximates fair value due to the relatively short-term nature of these instruments.

**Investments and MBS**

The fair value of investments and MBS is based on quoted market prices. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments. The carrying value of FHLB stock approximates fair value based on the redemption provisions of the FHLB Seattle.

**Loans Held for Sale**

The fair values are based on the estimated value at which the loans could be sold in the secondary market considering the fair value of options and commitments to sell or issue mortgage loans.

**Loans Receivable**

The fair values of performing residential mortgage loans and home equity loans are estimated using current market comparable information for securitizable mortgages, adjusting for credit and other relevant characteristics. The fair value of performing commercial real estate construction, permanent financing, consumer and commercial loans is estimated by discounting the cash flows using interest rates that consider the current credit and interest rate risk inherent in the loans and current economic and lending conditions.

The fair value of nonperforming loans is estimated by discounting management's current estimate of future cash flows using a rate estimated to be commensurate with the risks involved or the underlying collateral.

**Deposits**

The fair values for deposits subject to immediate withdrawal such as interest and non-interest bearing checking, regular savings, and money market deposit accounts, are equal to the amounts payable on demand at the reporting date. The carrying amounts for variable-rate certificates of deposit and other time deposits approximate their fair value at the reporting date. Fair values for fixed-rate time deposits are estimated by discounting future cash flows using interest rates currently offered on time deposits with similar remaining maturities.

**Borrowings**

The carrying amounts of short-term borrowings under repurchase agreements, federal funds purchased, short-term FHLB Seattle advances and other short-term borrowings approximate their fair values due to the relatively short period of time between the origination of the instruments and their expected payment. The fair value of advances under lines of credit approximates their carrying value because such advances bear variable rates of interest. The fair value of long-term FHLB Seattle advances and other long-term borrowings is estimated using discounted cash flow analyses based on Sterling's current incremental borrowing rates for similar types of borrowing arrangements with similar remaining terms.

**Table of Contents**

**Sterling Financial Corporation**  
**Notes to Consolidated Financial Statements**  
**For the Years Ended December 31, 2005, 2004 and 2003**

**22. Fair Values of Financial Instruments, Continued:**

The carrying and fair values of financial instruments were the following (in thousands):

|                                 | 2005               |            | December 31,<br>2004 |            |
|---------------------------------|--------------------|------------|----------------------|------------|
|                                 | Carrying<br>Amount | Fair Value | Carrying<br>Amount   | Fair Value |
| Financial assets:               |                    |            |                      |            |
| Cash and cash equivalents       | \$ 132,169         | \$ 132,169 | \$ 94,468            | \$ 94,468  |
| Investments and MBS:            |                    |            |                      |            |
| Available for sale              | 2,076,615          | 2,076,615  | 2,157,136            | 2,157,136  |
| Held to maturity                | 51,924             | 51,748     | 47,449               | 47,467     |
| Loans held for sale             | 7,894              | 7,894      | 14,224               | 14,224     |
| Loans receivable, net           | 4,885,916          | 4,883,265  | 4,251,877            | 4,268,392  |
| Accrued interest receivable     | 35,805             | 35,805     | 27,479               | 27,479     |
| Financial liabilities:          |                    |            |                      |            |
| Non-maturity deposits           | 2,418,903          | 2,418,903  | 2,092,274            | 2,092,274  |
| Deposits with stated maturities | 2,387,398          | 2,382,189  | 1,771,022            | 1,780,328  |
| Borrowings                      | 2,165,826          | 2,115,145  | 2,547,767            | 2,676,123  |
| Accrued interest payable        | 18,169             | 18,169     | 14,842               | 14,842     |

The fair value estimates above do not include the value of mortgage servicing rights on Sterling's residential and commercial mortgage servicing portfolio, which totaled approximately \$1.42 billion and \$967.4 million at December 31, 2005 and 2004, respectively. The gross fair value of these rights is estimated to be approximately \$7.1 million and \$5.3 million at December 31, 2005 and 2004, respectively. The carrying amount of all mortgage servicing rights was approximately \$5.4 million and \$4.1 million at December 31, 2005 and 2004, respectively.

**23. Related-Party Transactions:**

One of Sterling's directors is a principal in a law firm that provides legal services to Sterling. During the years ended December 31, 2005, 2004 and 2003, Sterling incurred legal fees of approximately \$1.9 million, \$2.2 million and \$2.0 million, respectively, related to services provided by this firm.

At December 31, 2005 and 2004, loans outstanding to directors and executive officers were \$16.3 million and \$10.3 million, respectively. Related party loans and deposits are transacted as part of Sterling's normal course of business, and are not subject to preferential terms or conditions.

**F-41**

**Table of Contents****Sterling Financial Corporation****Notes to Consolidated Financial Statements****For the Years Ended December 31, 2005, 2004 and 2003****24. Parent Company-Only Financial Information:**

The following Sterling Financial Corporation parent company-only financial information should be read in conjunction with the other notes to consolidated financial statements. The accounting policies for the parent company-only financial statements are the same as those used in the presentation of the consolidated financial statements other than the parent company-only financial statements account for the parent company's investments in its subsidiaries under the equity method (in thousands).

| <b>Condensed Balance Sheets</b>            | <b>December 31,</b> |             |
|--|---------------------|-------------|
|  | <b>2005</b>         | <b>2004</b> |
| Assets:                                    |                     |             |
| Cash and cash equivalents                  | \$ 15,706           | \$ 19,245   |
| Investments in subsidiaries:               |                     |             |
| Sterling Savings Bank                      | 598,394             | 566,419     |
| Tri-Cities Mortgage Company                | 32                  | 32          |
| Sterling Capital Trusts                    | 2,415               | 2,415       |
| Klamath First Capital Trusts               | 867                 | 867         |
| Receivable from subsidiaries               | 3,260               | 9,744       |
| Available for sale investments             | 55                  | 55          |
| Other assets                               | 2,366               | 1,732       |
| Total assets                               | \$ 623,095          | \$ 600,509  |
| Liabilities and Shareholders' Equity:      |                     |             |
| Accrued expenses payable                   | \$ 7,671            | \$ 2,948    |
| Term note payable                          | 0                   | 19,000      |
| Junior Subordinated Debentures             | 108,707             | 108,685     |
| Due to affiliates                          | 32                  | 32          |
| Shareholders' equity                       | 506,685             | 469,844     |
| Total liabilities and shareholders' equity | \$ 623,095          | \$ 600,509  |

**F-42**

**Table of Contents**

**Sterling Financial Corporation**  
**Notes to Consolidated Financial Statements**  
**For the Years Ended December 31, 2005, 2004 and 2003**  
**24. Parent Company-Only Financial Information, Continued:**

|  | <b>Years Ended December 31,</b> |             |             |
|--|---------------------------------|-------------|-------------|
|  | <b>2005</b>                     | <b>2004</b> | <b>2003</b> |
|  | (in thousands)                  |             |             |
| <b>Condensed Statements of Income</b>  |                                 |             |             |
| Interest income  | \$ 748                          | \$ 626      | \$ 269      |
| Interest expense   | (8,618)                         | (8,630)     | (7,653)     |
| Net interest expense   | (7,870)                         | (8,004)     | (7,384)     |
| Equity in net earnings of subsidiary   | 68,339                          | 63,247      | 41,586      |
| Operating expenses   | (3,433)                         | (2,778)     | (1,745)     |
| Other noninterest income (expense)   | 0                               | (238)       | (1,464)     |
| Income before income taxes   | 57,036                          | 52,227      | 30,993      |
| Income tax benefit   | 4,183                           | 4,078       | 3,920       |
| Net income   | \$ 61,219                       | \$ 56,305   | \$ 34,913   |
| <b>Condensed Statements of Cash Flows</b>                                    |                                 |             |             |
| Cash flows from operating activities:  |                                 |             |             |
| Net income   | \$ 61,219                       | \$ 56,305   | \$ 34,913   |
| Adjustments to reconcile net income to net cash used in operating activities | (65,444)                        | (64,359)    | (42,815)    |
| Net cash used in operating activities  | (4,225)                         | (8,054)     | (7,902)     |
| Cash flows from investing activities:  |                                 |             |             |
| Investments in subsidiaries, net   | 0                               | 0           | (436)       |
| Repayment of advances to subsidiaries  | 6,484                           | 6,862       | 0           |
| Dividends from subsidiary  | 11,616                          | 11,616      | 11,616      |
| Other  | 0                               | 3,037       | 0           |
| Net cash provided by investing activities                                    | 18,100                          | 21,515      | 11,180      |
| Cash flows from financing activities:  |                                 |             |             |
| Proceeds from other borrowings   | 0                               | 0           | 55,672      |
| Repayment of other borrowings  | (19,000)                        | (33,000)    | (44,237)    |
| Proceeds from exercise of stock options, net of repurchases                  | 3,411                           | 7,083       | 1,223       |
| Payments for fractional shares and merger costs                              | (14)                            | (240)       | (30)        |
| Deferred financing costs   | (75)                            | 0           | (732)       |
| Cash from mergers and acquisitions   | 0                               | 5,152       | 2,698       |
| Dividends paid   | (1,736)                         | 0           | 0           |

|   |           |           |           |
|---|-----------|-----------|-----------|
| Net cash provided by (used in) financing activities | (17,414)  | (21,005)  | 14,594    |
| Net change in cash and cash equivalents             | (3,539)   | (7,544)   | 17,872    |
| Cash and cash equivalents, beginning of year        | 19,245    | 26,789    | 8,917     |
| Cash and cash equivalents, end of year              | \$ 15,706 | \$ 19,245 | \$ 26,789 |

**F-43**

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**Table of Contents****Sterling Financial Corporation****Notes to Consolidated Financial Statements****For the Years Ended December 31, 2005, 2004 and 2003****24. Parent Company-Only Financial Information, Continued:**

Federal law prohibits Sterling Financial Corporation from borrowing from its subsidiary bank unless the loans are collateralized by specified assets and are generally limited to 10% of the subsidiary's bank capital and surplus. Current income taxes are allocated to Sterling and its subsidiaries as if they were separate tax paying entities. The payment of dividends to Sterling Financial Corporation by its bank subsidiary is subject to various federal and state regulatory limitations. Under current regulations, at December 31, 2005, the bank subsidiary could have declared approximately \$138.3 million of aggregate dividends in addition to amounts previously paid.

**25. Business Combinations:****KFBI Acquisition**

On January 2, 2004, Sterling completed its acquisition of KFBI, in which KFBI was merged with and into Sterling, with Sterling being the surviving corporation, and KFBI's wholly owned subsidiary, Klamath First Federal Savings and Loan Association, was merged with and into Sterling's wholly owned subsidiary, Sterling Savings Bank, with Sterling Savings Bank being the surviving institution. The acquisition was structured as a tax-free reorganization and was accounted for under the purchase method of accounting. Accordingly, the assets and liabilities of KFBI were recorded by Sterling at their respective fair values as of the acquisition date, and the results of operations have been included with those of Sterling since the acquisition date.

Under the terms of the KFBI acquisition, each share of KFBI common stock was converted into 0.77 shares of Sterling common stock. Sterling issued 5,431,067 shares of common stock in exchange for all of the stock of KFBI and assumed all outstanding KFBI options, which were converted into options to purchase 433,529 shares of Sterling's common stock. The aggregate purchase price was \$145.2 million, including \$3.8 million related to the value of KFBI's vested stock options and \$141.4 million related to the value of KFBI's common stock. The value of the common shares issued by Sterling was \$26.06 per share, which was determined based on the average market closing price of Sterling's common stock five business days prior to and subsequent to the merger announcement date.

Sterling recorded goodwill in the acquisition. Some of the factors that contributed to the aggregate purchase price that resulted in this goodwill were: management's projection that the acquisition would be immediately accretive to earnings; and the expansion of Sterling's geographic footprint in the Pacific Northwest, particularly in the state of Oregon, as a result of the acquisition.

As a result of this acquisition, Sterling added 48 retail branches and significantly increased its deposit share in Oregon, and increased its branch network to over 130 branches serving Washington, Oregon, Idaho and Montana. With this expanded branch network, Sterling has strengthened its position as a leading regional community bank. This acquisition is consistent with Sterling's strategy to become the leading community bank in the Pacific Northwest. KFBI's strong deposit base has complemented Sterling's asset growth strategy, while the combined branch network and access to capital have given Sterling the opportunity to continue its growth in the region.

**F-44**

**Table of Contents**

**Sterling Financial Corporation**  
**Notes to Consolidated Financial Statements**  
**For the Years Ended December 31, 2005, 2004 and 2003**

**25. Business Combinations, Continued:**

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

|                               | <b>Amount</b>    |
|-------------------------------|------------------|
| Cash and cash equivalents     | \$ 44,894        |
| Investments and ABS           | 778,118          |
| Loans receivable, net         | 564,452          |
| Goodwill                      | 65,721           |
| Core deposit intangible       | 19,189           |
| Other assets                  | 74,931           |
| <br>Total assets acquired     | <br>\$ 1,547,305 |
| <br>Deposits                  | <br>\$ 987,864   |
| Other borrowings              | 392,679          |
| Other liabilities             | 21,595           |
| <br>Total liabilities assumed | <br>1,402,138    |
| <br>Net assets acquired       | <br>\$ 145,167   |

All of the acquired core deposit intangible and goodwill was allocated to the Community Banking segment of Sterling. The acquired core deposit intangible asset has a weighted-average useful life of approximately 10 years. Of the \$65.7 million of goodwill acquired, none is expected to be deductible for income tax purposes.

**PWWA Acquisition**

On November 30, 2004, INTERVEST acquired PWWA, by merging PWWA with and into INTERVEST, with INTERVEST being the surviving entity in the merger. This acquisition expanded Sterling's capacity to originate commercial real estate loans and increased Sterling's commercial real estate servicing portfolio by \$392.2 million. Under the acquisition agreement, Sterling issued 24,008 shares of common stock in exchange for the fair values of the assets, liabilities and servicing portfolio of PWWA, which were assumed by INTERVEST. As of December 31, 2005, an additional 36,012 shares of Sterling's common stock remain contingently issuable under the acquisition agreement, with such issuance contingent upon the attainment of certain performance targets by the combined operations over the next two fiscal years ending December 31, 2007. As of December 31, 2005, 12,004 of these contingently issuable shares had been earned, and were issued in January 2006. As a result of the acquisition, Sterling has recorded goodwill of \$1.9 million, which was allocated to the Community Banking segment of Sterling. The results of operations of PWWA have been included with those of Sterling since the acquisition date.

**26. Subsequent Events:**

Subsequent to the end of Sterling's 2005 fiscal year, on February 13, 2006, Sterling announced that it had entered into a definitive agreement to acquire Lynnwood Financial Group, Inc., the parent company of Golf Savings Bank, pursuant to which Lynnwood Financial Group, Inc. would merge with and into Sterling, with Sterling being the surviving entity. Lynnwood's subsidiaries, Golf Savings Bank and Golf Escrow Corporation, are expected to continue operations as wholly-owned subsidiaries of Sterling. The transaction, which is valued at approximately \$65.3 million, is expected to close in the third quarter of 2006, pending receipt of regulatory and Lynnwood shareholder approvals and satisfaction of their customary closing conditions, and is expected to be accretive to Sterling's earnings per share in



2006.

On February 28, 2006, Sterling announced a quarterly cash dividend of \$0.06 per share of common stock, payable on April 13, 2006 to shareholders of record as of March 31, 2006.

**F-45**

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**Table of Contents**

| <b>Exhibit No.</b> | <b>Exhibit Index</b>  |
|--------------------|---|
| 3.1                | Restated Articles of Incorporation of Sterling. Filed as Exhibit 3.1 to Sterling's report on Form 10-Q filed May 15, 2003, and incorporated by reference herein.  |
| 3.2                | Articles of Amendment of Restated Articles of Incorporation of Sterling. Filed as Exhibit 3.1 to Sterling's current report on Form 8-K filed September 2, 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. |
| 10.1               | Sterling Financial Corporation 2001 Long-Term Incentive Plan. Filed as Exhibit A to Sterling's Proxy Statement in connection with the Annual Meeting of Shareholders held on April 24, 2001, and incorporated by reference herein.  |
| 10.2               | Sterling Financial Corporation Amended and Restated Deferred Compensation Plan, effective July 1, 1999. Filed as Exhibit 10.5 to Sterling's Annual Report on Form 10-K dated February 22, 2000, and incorporated by reference herein.   |
| 10.3               | Sterling Financial Corporation 1998 Long-Term Incentive Plan. Filed as Exhibit A to Sterling's Proxy Statement in connection with the Annual Meeting of Shareholders held on April 28, 1998, and incorporated by reference herein.  |
| 10.4               | Sterling Savings Bank 1992 Incentive Stock Option Plan. Filed as Exhibit 10.2 to Sterling's Form S-4 dated August 28, 1992, and incorporated by reference herein.   |
| 10.5               | Sterling Savings Bank Employment Savings and Incentive Plan and Trust dated September 21, 1990. Filed as Exhibit 10.4 to Sterling's Form S-4 dated August 28, 1992 and incorporated by reference herein.  |
| 10.6               | Sterling Financial Corporation and Sterling Savings Bank Supplemental Executive Retirement Plan. Filed as Exhibit 10.9 to Sterling's Annual Report on Form 10-K dated March 21, 2004, and incorporated by reference herein.   |
| 10.7               | Sterling Financial Corporation Dividend Reinvestment and Direct Stock Purchase and Sale Plan. Included in Sterling's final prospectus dated December 30, 2005 related to the Registration Statement on Form S-3 dated December 20, 2005, and incorporated by reference herein.  |
| 12.1               | Statement regarding Computation of Return on Average Shareholders' Equity. Filed herewith.  |
| 12.2               | Statement regarding Computation of Return on Average Assets. Filed herewith.  |

- 21.1 List of Subsidiaries of Sterling. Filed herewith.
- 23.1 Consent of BDO Seidman, LLP. Filed herewith.
- 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.

E-1

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**Table of Contents**

| <b>Exhibit No.</b> | <b>Exhibit Index</b>   |
|--------------------|--|
| 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-2