

STERLING FINANCIAL CORP /WA/

Form 10-K

February 28, 2007

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, 2006**
- ☐ **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**  
*(Address of principal executive offices)*

**99201**  
*(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 ☒

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

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 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, 2006, the aggregate market value of the common equity held by non-affiliates of the registrant, computed by reference to the average of the bid and asked prices on such date as reported by The NASDAQ National Market, was \$1.07 billion.

The number of shares outstanding of the registrant's common stock, par value \$1.00 per share, as of January 31, 2007 was 42,200,432.

#### **DOCUMENTS INCORPORATED BY REFERENCE**

Specific portions of the registrant's Proxy Statement for its 2007 annual meeting of shareholders are incorporated by reference into Part III hereof.

---

**STERLING FINANCIAL CORPORATION**

**DECEMBER 31, 2006 ANNUAL REPORT ON FORM 10-K  
TABLE OF CONTENTS**

	<b>Page</b>
<b><u>PART I</u></b>	1
<b><u>Item 1. 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>	14
<u>Subsidiaries</u>	16
<u>Competition</u>	18
<u>Personnel</u>	18
<u>Environmental Laws</u>	18
<u>Regulation</u>	18
<u>Forward-Looking Statements</u>	24
<u>Where You Can Find More Information</u>	25
<b><u>Item 1A. Risk Factors</u></b>	25
<b><u>Item 1B. Unresolved Staff Comments</u></b>	31
<b><u>Item 2. Properties</u></b>	31
<b><u>Item 3. Legal Proceedings</u></b>	31
<b><u>Item 4. Submission of Matters to a Vote of Security Holders</u></b>	31
<b><u>PART II</u></b>	32
<b><u>Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u></b>	32
<u>Stock Market and Dividend Information</u>	32
<b><u>Item 6. Selected Financial Data</u></b>	34
<b><u>Item 7. 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>	36
<u>Results of Operations for the Years Ended December 31, 2006 and 2005</u>	38
<u>Results of Operations for the Years Ended December 31, 2005 and 2004</u>	42
<u>Financial Position</u>	44
<u>Asset and Liability Management</u>	45
<u>Liquidity and Capital Resources</u>	48
<u>Off-Balance Sheet Arrangements and Aggregate Contractual Obligations</u>	50
<u>Capital</u>	51
<u>Goodwill Litigation</u>	51
<u>New Accounting Policies</u>	51
<u>Effects of Inflation and Changing Prices</u>	52
<b><u>Item 7A. Quantitative and Qualitative Disclosures About Market Risk</u></b>	52

<b><u>Item 8.</u></b>	<b><u>Financial Statements and Supplementary Data</u></b>	52
<b><u>Item 9.</u></b>	<b><u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u></b>	52
<b><u>Item 9A.</u></b>	<b><u>Controls and Procedures</u></b>	52
	<u>Management's Report on Internal Control Over Financial Reporting</u>	53
	<u>Report of Independent Registered Public Accounting Firm</u>	54
<b><u>Item 9B.</u></b>	<b><u>Other Information</u></b>	55
<b><u>PART III</u></b>		55
<b><u>Item 10.</u></b>	<b><u>Directors, Executive Officers and Corporate Governance</u></b>	55
<b><u>Item 11.</u></b>	<b><u>Executive Compensation</u></b>	55
<b><u>Item 12.</u></b>	<b><u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u></b>	55
<b><u>Item 13.</u></b>	<b><u>Certain Relationships and Related Transactions, and Director Independence</u></b>	55
<b><u>Item 14.</u></b>	<b><u>Principal Accounting Fees and Services</u></b>	55
<b><u>PART IV</u></b>		56
<b><u>Item 15.</u></b>	<b><u>Exhibits, Financial Statement Schedules</u></b>	56
<b><u>SIGNATURES</u></b>		57
<u>EXHIBIT 10.6</u>		
<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>		

---

**Table of Contents**

**PART I**

**Item 1. Business**

**General**

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

Sterling provides personalized, quality financial services and Perfect Fit banking products to its customers consistent with its Hometown Helpful philosophy. Sterling believes that its dedication to personalized service has enabled it to grow both its retail deposit base and its lending portfolio in the western United States. With \$9.83 billion in total assets at December 31, 2006, Sterling originates loans and attracts Federal Deposit Insurance Corporation ( FDIC ) insured deposits from the general public through 166 financial service centers located in Washington, Oregon, Idaho and Montana. In addition, Sterling originates loans through Golf Savings Bank and Action Mortgage residential loan production offices and through INTERVEST commercial real estate lending offices throughout the western United States. Sterling also markets fixed income and equity products, mutual funds, fixed and variable annuities and other financial products through Harbor Financial service representatives located throughout Sterling's financial service center network.

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

**Company Growth**

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

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

## **Table of Contents**

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

On September 17, 2006, Sterling entered into a definitive agreement to acquire Northern Empire Bancshares, a California corporation ( Northern Empire ). Under the terms of the agreement, Northern Empire will be merged with and into Sterling, with Sterling being the surviving corporation in the merger. The agreement also provides that Sterling may elect to merge Northern Empire's financial institution subsidiary, Sonoma National Bank, with and into Sterling's financial institution subsidiary, Sterling Savings Bank, with Sterling Savings Bank being the surviving institution. Under the terms of the agreement, each share of Northern Empire common stock would be converted into 0.8050 shares of Sterling common stock and \$2.71 in cash, subject to certain conditions. The transaction, which was valued at approximately \$335 million as of the date that the parties agreed to merge, is expected to close on February 28, 2007.

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

## **Profitability Drivers**

We expect to increase our profitability in the future by:

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

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

expanding products and services for commercial 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 repositioned its loan portfolio and operations to be more like that of a community bank. Commercial real estate, commercial banking, consumer and construction loans generally produce higher yields than residential permanent mortgage loans. Such loans, however, generally involve a higher degree of risk than financing residential real estate.

**Table of Contents**

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

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

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

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

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

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

**Table of Contents**

residential loans both on a servicing-released and servicing-retained basis primarily to the Federal Home Loan Mortgage Corporation ( FHLMC ) and to the Federal National Mortgage Association ( FNMA ). Sterling endeavors to underwrite residential loans in compliance with these agencies' underwriting standards. Loans sold into the secondary market are all sold 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.*

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

*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.

**Table of Contents**

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

	<b>2006</b>		<b>Years Ended December 31,</b>		<b>2004</b>	
	<b>Amount</b>	<b>%</b>	<b>Amount</b>	<b>%</b>	<b>Amount</b>	<b>%</b>
	<b>(Dollars in thousands)</b>					
Mortgage permanent:						
One- to four-family residential	\$ 830,619	16.7	\$ 461,414	11.9	\$ 400,391	13.7
Multifamily residential	4,215	0.1	57,571	1.5	43,395	1.5
Commercial real estate	131,001	2.6	218,396	5.6	241,754	8.3
	965,835	19.4	737,381	19.0	685,540	23.5
Mortgage construction:						
One- to four-family residential	1,425,248	28.7	1,106,632	28.5	719,146	24.6
Multifamily residential	156,932	3.2	175,018	4.5	102,970	3.5
Commercial real estate	752,458	15.1	519,893	13.4	203,401	7.0
	2,334,638	47.0	1,801,543	46.4	1,025,517	35.1
Total mortgage loans	3,300,473	66.4	2,538,924	65.4	1,711,057	58.6
Commercial and consumer:						
Commercial banking	1,154,304	23.2	898,768	23.1	818,594	28.1
Consumer direct	327,027	6.6	353,840	9.1	332,076	11.4
Consumer indirect	189,505	3.8	90,096	2.4	56,403	1.9
Total commercial and consumer loans	1,670,836	33.6	1,342,704	34.6	1,207,073	41.4
Total loans originated	\$ 4,971,309	100.0	\$ 3,881,628	100.0	\$ 2,918,130	100.0

**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:

	2006		2005		December 31, 2004		2003		2002
	Amount	%	Amount	%	Amount	%	Amount	%	Amount
(Dollars in thousands)									
permanent:									
-family	\$ 654,661	9.2	\$ 488,633	9.9	\$ 794,632	18.4	\$ 407,999	13.8	\$ 358,359
residential	263,053	3.7	332,211	6.7	184,754	4.3	167,220	5.7	161,547
real estate	795,386	11.2	792,219	16.0	699,879	16.3	463,191	15.7	458,712
	1,713,100	24.1	1,613,063	32.6	1,679,265	39.0	1,038,410	35.2	978,618
construction:									
-family	1,429,772	20.1	591,362	11.9	356,644	8.3	271,480	9.2	280,514
residential	189,819	2.7	143,272	2.9	102,166	2.4	127,424	4.3	96,297
real estate	671,291	9.4	286,868	5.8	194,085	4.5	154,061	5.2	104,108
	2,290,882	32.2	1,021,502	20.6	652,895	15.2	552,965	18.7	480,919
age loans and	4,003,982	56.3	2,634,565	53.2	2,332,160	54.2	1,591,375	53.9	1,459,537
banking	2,069,086	29.1	1,531,079	30.9	1,311,197	30.4	948,304	32.2	655,727
direct	749,626	10.5	618,528	12.5	543,895	12.6	309,931	10.5	246,578
indirect	288,704	4.1	166,143	3.4	120,894	2.8	99,697	3.4	62,896
ercial and									
ans	3,107,416	43.7	2,315,750	46.8	1,975,986	45.8	1,357,932	46.1	965,201
receivable	7,111,398	100.0	4,950,315	100.0	4,308,146	100.0	2,949,307	100.0	2,424,738
s, net	(12,308)		(8,916)		(6,907)		(7,276)		(6,450)
receivable	7,099,090		4,941,399		4,301,239		2,942,031		2,418,288
or loan	(83,689)		(55,483)		(49,362)		(35,605)		(27,866)
able, net	\$ 7,015,401		\$ 4,885,916		\$ 4,251,877		\$ 2,906,426		\$ 2,390,422

*Contractual Principal Payments.* The following table sets forth the scheduled contractual principal repayments for Sterling's loan portfolio at December 31, 2006. Demand loans, loans having no stated repayment schedule



**Table of Contents**

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 Outstanding at December 31, 2006</b>	<b>Principal Payments Contractually Due in Fiscal Years</b>		
		<b>2007</b>	<b>2008-2011</b>	<b>Thereafter</b>
		<b>(In thousands)</b>		
Mortgage permanent:				
Fixed rate	\$ 785,819	\$ 50,989	\$ 191,245	\$ 543,585
Variable rate	927,281	67,120	263,518	596,643
Mortgage construction	2,290,882	1,562,065	682,318	46,499
Consumer direct	749,626	271,566	139,410	338,650
Consumer indirect	288,704	60,201	201,032	27,471
Commercial banking	2,069,086	1,071,813	509,287	487,986
	\$ 7,111,398	\$ 3,083,754	\$ 1,986,810	\$ 2,040,834

*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, 2006 and 2005, Sterling serviced for itself and for other investors, residential mortgage loans totaling \$1.17 billion and \$972.5 million, respectively. Of such mortgage loans, \$621.6 million in 2006 and \$606.7 million in 2005 were primarily serviced for FHLMC and FNMA. Sterling's ability to continue as a seller/servicer for these agencies is dependent upon meeting their qualifications. Sterling currently meets all applicable requirements.

Sterling receives a fee for servicing commercial and multifamily real estate loans for other investors. This fee generally ranges from 5 to 25 basis points of the unpaid principal balance. At December 31, 2006 and 2005, Sterling serviced for itself and other investors, commercial and multifamily real estate loans totaling \$2.57 billion and \$1.74 billion, respectively.

*Secondary Market Activities.* Sterling has developed correspondent relationships with a number of mortgage companies and financial institutions to facilitate the origination or purchase and sale of mortgage loans in the secondary market on either a participation or whole loan basis. Substantially all of 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, 2006, 2005 and 2004, Sterling sold approximately



\$54.9 million, \$125.5 million and \$16.3 million in loans under participation agreements, resulting in net gains of \$747,000, \$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 2006, 99% 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 94% in 2005.

In 2006, 1% of Sterling's sales of conventional, FHA and VA insured loans were sold into the secondary market on a servicing-retained basis, compared with 6% in 2005. 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, 2006 and 2005,

## **Table of Contents**

Sterling had recorded as net assets \$7.3 million and \$5.4 million in servicing rights, respectively. See Note 4 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 \$1.36 billion and \$925.8 million at December 31, 2006 and 2005, respectively. Sterling also had secured and unsecured commercial and personal lines of credit, the undisbursed portion of which was approximately \$944.7 million and \$826.2 million at December 31, 2006 and 2005, respectively. See Note 16 of Notes to Consolidated Financial Statements.

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

As part of its mortgage banking activities, Sterling issues interest rate lock commitments ( rate locks ) to prospective borrowers on residential one-to-four family mortgage loan applications. Pricing for the sale of these loans is fixed with various qualified investors, such as FNMA, under both non-binding ( best-efforts ) and binding ( mandatory ) delivery programs at or near the time the interest rate is locked with the borrowers. For mandatory delivery programs, Sterling hedges IRR by entering into offsetting forward sale agreements on MBS with third parties. Risks inherent in mandatory delivery programs include the risk that if Sterling does not close the loans subject to rate locks, it is nevertheless obligated to deliver MBS to the counterparty under the forward sale agreement. Sterling could incur significant costs in acquiring replacement loans or MBS and such costs could have a material adverse effect on mortgage banking operations in future periods. At December 31, 2006, Sterling did not have any loans locked with investors under mandatory delivery programs, nor hold any offsetting forward sale agreements on MBS. As of December 31, 2006, Sterling had entered into best efforts forward commitments to sell \$142.6 million of mortgage loans.

Rate lock commitments to borrowers and best-effort loan delivery commitments from investors are off-balance-sheet commitments that are considered to be derivatives. Sterling accounts for these commitments by recording their estimated fair value on its balance sheet. As of December 31, 2006, Sterling recorded an asset of approximately \$482,000 for the estimated fair value of rate locks issued and a liability of approximately \$482,000 for the estimated fair value of delivery commitments received. As of December 31, 2005, Sterling had loans subject to rate locks under a mandatory delivery program and held off-setting forward sale agreements for MBS. Correspondingly, as of December 31, 2005, Sterling recorded an asset of \$147,000 for the fair value of rate locks and a liability of \$25,000 for the fair value of forward sale agreements.

Sterling enters into interest rate swap derivative contracts with customers. The IRR on these contracts is offset by entering into comparable dealer swaps. These contracts are carried at fair value.

*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

**Table of Contents**

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 \$48.4 million at December 31, 2006, from \$59.6 million at December 31, 2005. As a percentage of total assets, classified assets decreased from the prior year. The percentage of classified assets to total assets was 0.49% and 0.79% at December 31, 2006 and 2005, 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, 2006, Sterling's assets classified as loss totaled \$1.4 million compared to \$2.2 million at December 31, 2005. 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.

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>2006</b>	<b>2005</b>	<b>2004</b>
	<b>(Dollars in thousands)</b>		
Balance at beginning of period	\$ 779	\$ 1,865	\$ 4,226
Loan foreclosures and other additions	4,581	2,271	4,445
Improvements and other changes	(244)	331	(132)
Sales	(894)	(3,665)	(6,669)
Provisions for losses	(170)	(23)	(5)
Balance at end of period	\$ 4,052	\$ 779	\$ 1,865

*Major Classified Loans.* Within Sterling's classified loans as of December 31, 2006, three borrowers each held loans that in the aggregate exceeded \$4.0 million. These loans, which together constitute 30% of classified assets, included the following:

Sterling holds commercial loans for auto dealership flooring lines and equipment, secured by auto inventory, real estate and personal guarantees. The aggregate carrying value of these loans at December 31, 2006 was \$5.1 million. These loans have been classified due to delinquency and because the borrower has been selling inventory out of trust. These loans are currently in default.

Sterling holds commercial loans secured by equipment and real estate. The aggregate carrying value of these loans at December 31, 2006 was \$5.0 million. These loans have been classified due to operating losses. These loans remain

current.

Sterling holds commercial loans for auto dealership flooring lines. The aggregate carrying value of these loans at December 31, 2006 was \$4.4 million. These loans are secured by auto inventory and real estate. These loans remain current under revisions to lending arrangement.

*Major Real Estate Owned.* At December 31, 2006, the aggregate value of REO properties was \$4.1 million, with the majority representing two hotels.

*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

**Table of Contents**

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.

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

	<b>2006</b>	<b>2005</b>	<b>December 31, 2004</b>	<b>2003</b>	<b>2002</b>
	<b>(Dollars in thousands)</b>				
Nonaccrual loans	\$ 7,107	\$ 6,542	\$ 10,738	\$ 16,208	\$ 16,278
Restructured loans	0	1,081	1,305	1,164	594
Total nonperforming loans	7,107	7,623	12,043	17,372	16,872
Real estate owned(1)	4,052	779	1,865	4,226	3,953
Total nonperforming assets	\$ 11,159	\$ 8,402	\$ 13,908	\$ 21,598	\$ 20,825
Ratio of total nonperforming assets to total assets	0.11%	0.11%	0.20%	0.50%	0.59%
Ratio of total nonperforming loans to gross loans	0.10%	0.15%	0.28%	0.59%	0.70%
Ratio of allowance for estimated losses on loans to total nonperforming loans(2)	1437.0%	975.9%	538.3%	216.6%	174.3%

(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 \$1,379,000, \$2,159,000, \$3,528,000, \$2,897,000 and \$2,067,000 at December 31, 2006, 2005, 2004, 2003 and 2002, 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 \$249,000, \$258,000, and \$659,000 was recorded on these loans during the years ended December 31, 2006, 2005 and 2004, respectively. Additional interest income of \$321,000, \$693,000 and \$1,348,000 would have been recorded during the years ended December 31, 2006, 2005 and 2004, 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.

**Table of Contents**

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 3 of Notes to Consolidated Financial Statements.

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>2006</b>	<b>2005</b>	<b>2004</b>	<b>2003</b>	<b>2002</b>
	<b>(Dollars in thousands)</b>				
Balance at beginning of period	\$ 55,483	\$ 49,362	\$ 35,605	\$ 27,866	\$ 20,599
Charge-offs:					
Mortgage permanent	(32)	(37)	(59)	(165)	(48)
Mortgage construction	(12)	(19)	(645)	(106)	(868)
Consumer direct	(619)	(1,107)	(1,373)	(1,146)	(954)
Consumer indirect	(823)	(449)	(370)	(445)	(407)
Commercial banking	(2,919)	(8,039)	(3,036)	(2,391)	(2,776)
Total charge-offs	(4,405)	(9,651)	(5,483)	(4,253)	(5,053)
Recoveries:					
Mortgage permanent	5	6	25	42	19
Mortgage construction	20	0	2	3	2
Consumer direct	193	237	214	160	208
Consumer indirect	310	201	111	149	170
Commercial banking	225	128	16	268	54
Total recoveries	753	572	368	622	453
Net charge-offs	(3,652)	(9,079)	(5,115)	(3,631)	(4,600)
Provisions for loan losses	18,703	15,200	12,150	10,500	11,867
Allowance for losses on assets acquired	13,155	0	6,722	870	0
Balance at end of period	\$ 83,689	\$ 55,483	\$ 49,362	\$ 35,605	\$ 27,866



Allowances allocated to loans classified as loss	\$ 1,379	\$ 2,159	\$ 3,528	\$ 2,897	\$ 2,067
Ratio of net charge-offs to average loans outstanding during the period	0.06%	0.20%	0.13%	0.13%	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:

		2006		2005		December 31, 2004		2003		2002	
		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	\$ 13,782	24.1	\$ 14,576	32.6	\$ 10,632	39.0	\$ 4,902	35.2	\$ 2,881	40.0
Mortgage	construction	17,925	32.2	8,016	20.6	6,264	15.2	6,336	18.7	6,199	19.0
Consumer	direct	8,205	10.5	6,795	12.5	7,247	12.6	3,843	10.5	2,986	10.0
Consumer	indirect	2,880	4.1	1,205	3.4	1,156	2.8	1,676	3.4	1,349	2.0
Commercial banking		40,082	29.1	23,626	30.9	23,710	30.4	17,979	32.2	14,014	27.0
Allocated		815	N/A	1,265	N/A	353	N/A	869	N/A	437	N/A
		\$ 83,689	100.0	\$ 55,483	100.0	\$ 49,362	100.0	\$ 35,605	100.0	\$ 27,866	100.0

**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, 2006 and 2005, investments and MBS classified as held to maturity were \$93.1 million and \$51.9 million, respectively. See MD&A Critical Accounting Policies *Investments and MBS*.

At December 31, 2006 and 2005, investments and MBS classified as available for sale were \$1.82 billion and \$2.08 billion, respectively. The carrying value of these investments and MBS at December 31, 2006 and 2005 includes net unrealized losses of \$52.8 million and \$54.1 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.

**Table of Contents**

The following table provides the carrying values, contractual maturities and weighted average yields of Sterling's investment and MBS portfolio at December 31, 2006. 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 Than One Year</b>	<b>One to Five Years</b>	<b>Maturity Over Five to Ten Years (Dollars in thousands)</b>	<b>Over Ten Years</b>	<b>Total</b>
Mortgage-backed securities					
Balance	\$ 0	\$ 78,196	\$ 9,115	\$ 1,600,361	\$ 1,687,672
Weighted average yield	0.00%	3.94%	4.03%	4.82%	4.77%
U.S. government and agency obligations					
Balance	\$ 12,469	\$ 9,859	\$ 0	\$ 0	\$ 22,328
Weighted average yield	4.82%	3.94%	0.00%	0.00%	4.43%
FHLB Seattle stock, at cost					
Balance	\$ 0	\$ 0	\$ 0	\$ 91,897	\$ 91,897
Weighted average yield(1)	0.00%	0.00%	0.00%	0.39%	0.39%
Municipal bonds					
Balance	\$ 1,800	\$ 1,755	\$ 9,445	\$ 79,808	\$ 92,808
Weighted average yield(2)	3.64%	3.46%	4.10%	4.40%	4.33%
Other(3)					
Balance	\$ 80	\$ 175	\$ 0	\$ 18,686	\$ 18,941
Weighted average yield	3.20%	4.20%	0.00%	0.55%	0.60%
Total carrying value	\$ 14,349	\$ 89,985	\$ 18,560	\$ 1,790,752	\$ 1,913,646
Weighted average yield	4.66%	3.93%	4.07%	4.53%	4.49%

(1) FHLB Seattle resumed paying dividends during the second half of 2006.

(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.

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:

	<b>December 31,</b>	
<b>2006</b>	<b>2005</b>	<b>2004</b>

**(Dollars in thousands)**

Mortgage-backed securities	\$ 1,687,672	\$ 1,960,582	\$ 2,036,920
U.S. government and agency obligations	22,328	21,793	28,070
FHLB Seattle stock	91,897	76,626	74,846
Municipal bonds	92,808	50,907	47,449
Other	18,941	18,631	17,300
 Total	 \$ 1,913,646	 \$ 2,128,539	 \$ 2,204,585
 Available for sale	 \$ 1,820,583	 \$ 2,076,615	 \$ 2,157,136
Held to maturity	93,063	51,924	47,449
 Total	 \$ 1,913,646	 \$ 2,128,539	 \$ 2,204,585
 Weighted average yield	 4.49%	 4.46%	 4.50%

**Table of Contents****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, reverse repurchase agreements and other borrowings, proceeds from investments and MBS, and 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.* 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 transaction accounts, savings accounts, money market deposit accounts ( MMDA ), 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 5.6% and 8.9% of deposits at December 31, 2006 and 2005, respectively. Public funds are generally obtained by competitive bidding among qualifying financial institutions. Sterling had \$1.10 billion and \$628.3 million of brokered deposits at December 31, 2006 and 2005, respectively.

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,					
	2006		2005		2004	
	Average Balance	Weighted Average Interest Rate	Average Balance	Weighted Average Interest Rate	Average Balance	Weighted Average Interest Rate
	(Dollars in thousands)					
Time deposits	\$ 2,962,017	4.58%	\$ 2,041,122	3.35%	\$ 1,608,599	2.57%
Savings and MMDA	1,512,198	3.16	1,158,270	1.92	1,092,612	1.04
Transaction accounts:						
Interest-bearing	399,690	0.42	419,137	0.32	399,963	0.21
Noninterest-bearing	706,631	0.00	648,385	0.00	546,128	0.00
	\$ 5,580,536	3.32%	\$ 4,266,914	2.16%	\$ 3,647,302	1.47%

The following table shows the amounts and remaining maturities of time deposits that had balances of \$100,000 or more at December 31, 2006 and 2005:

	<b>December 31,</b>	
	<b>2006</b>	<b>2005</b>
	<b>(Dollars in thousands)</b>	
Three months or less	\$ 931,437	\$ 525,623
After three months through six months	644,825	332,184
After six months through twelve months	509,732	449,559
After twelve months	212,639	201,183
	\$ 2,298,633	\$ 1,508,549

## **Table of Contents**

Sterling has 163 automated teller machines ( ATM ). 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. Other borrowings increased from December 31, 2005 due to Sterling's wholly owned subsidiaries, Sterling Capital Trusts VII and VIII, issuing \$105.0 million of Trust Preferred Securities. Other borrowings also increased as a result of acquiring \$19.0 million of Trust Preferred Securities in the acquisition of Golf Savings 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 qualifying mortgages and MBS, or total advances from the FHLB Seattle. At December 31, 2006, 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 collateralized by certain loans or securities, 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, 2006, Sterling had advances totaling \$1.31 billion from the FHLB Seattle, which mature from 2007 through 2030 at interest rates ranging from 2.32% to 8.08%. See MD&A Liquidity and Capital Resources and Note 8 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 \$616.4 million and \$611.7 million in wholesale and retail reverse repurchase agreements outstanding at December 31, 2006 and 2005, 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 9 of Notes to Consolidated Financial Statements.

On August 21, 2006, Sterling entered into a \$30 million one-year variable-rate revolving credit agreement (the Credit Facility ) with Wells Fargo Bank, National Association, replacing a \$40 million credit facility Sterling previously had with Bank of Scotland. As of December 31, 2006, no amount was drawn on the credit facility. Amounts loaned pursuant to the Credit Facility will bear interest, at Sterling's election, at either two percent below prime, or at LIBOR plus 90 basis points. The Credit Facility contains representations and warranties, and negative and affirmative covenants by Sterling, including financial covenants and restrictions on certain actions by Sterling, such as Sterling's ability to incur debt, make investments and merge into or consolidate with other entities. The Credit Facility may be terminated and loans under the Credit Facility may be accelerated if an event of default occurs, as defined in the Credit Facility. Sterling is obligated to repay the principal balance of any advances issued pursuant to the Credit Facility on August 3, 2007.





**Table of Contents**

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>2006</b>	<b>2005</b>	<b>2004</b>
	<b>(Dollars in thousands)</b>		
Maximum amount outstanding at any month-end during the period:			
Short-term reverse repurchase agreements	\$ 235,495	\$ 821,363	\$ 779,012
Short-term advances	803,307	670,047	648,648
Average amount outstanding during the period:			
Short-term reverse repurchase agreements	\$ 160,702	\$ 634,838	\$ 630,057
Short-term advances	674,929	461,897	517,499
Weighted average interest rate paid during the period:			
Short-term reverse repurchase agreements	4.64%	3.23%	2.22%
Short-term advances	4.44%	3.15%	2.77%
Weighted average interest rate paid at end of period:			
Short-term reverse repurchase agreements	4.81%	4.07%	2.53%
Short-term advances	5.14%	3.39%	3.36%

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

	<b>2006</b>		<b>December 31, 2005</b>		<b>2004</b>	
	<b>Amount</b>	<b>%</b>	<b>Amount</b>	<b>%</b>	<b>Amount</b>	<b>%</b>
	<b>(Dollars in thousands)</b>					
FHLB Seattle advances:						
Short-term	\$ 803,307	37.1	\$ 670,047	30.9	\$ 562,238	22.1
Long-term	505,310	23.3	773,415	35.7	1,073,695	42.1
Securities sold subject to reverse repurchase agreements and funds purchased:						
Short-term	86,354	4.0	261,676	12.1	780,012	30.6
Long-term	530,000	24.5	350,000	16.2	0	0.0
Term note payable(1)	0	0.0	0	0.0	19,000	0.7
Trust Preferred Securities	236,772	10.9	108,707	5.0	108,685	4.3
Other	3,454	0.2	1,981	0.1	4,137	0.2
Total borrowings	\$ 2,165,197	100.0	\$ 2,165,826	100.0	\$ 2,547,767	100.0
Weighted average interest rate at end of period		5.17%		4.03%		3.36%

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

## **Subsidiaries**

Sterling's principal operating subsidiaries are Sterling Savings Bank and Golf Savings Bank. Sterling Savings Bank has three principal subsidiaries, which have been previously described: Action Mortgage, INTERVEST and

**Table of Contents**

Harbor Financial. Additionally, Sterling and Sterling Savings Bank have the following other wholly owned, direct subsidiaries:

***Sterling Financial Corporation.***

- (1) Golf Escrow Corporation was acquired in July 2006 and offers a full range of escrow closing services.
- (2) 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 10 of Notes to Consolidated Financial Statements.
- (3) 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 10 of Notes to Consolidated Financial Statements.
- (4) 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 10 of Notes to Consolidated Financial Statements.
- (5) 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 10 of Notes to Consolidated Financial Statements.
- (6) 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 10 of Notes to Consolidated Financial Statements.
- (7) Sterling Capital Trust VII ( SCT-VII ) was organized in June 2006 as a Delaware business trust. Sterling owns all the common equity of SCT-VII. The sole asset of SCT-VII is the Junior Subordinated Debentures-VII issued by Sterling. See Note 10 of Notes to Consolidated Financial Statements.
- (8) Sterling Capital Trust VIII ( SCT-VIII ) was organized in September 2006 as a Delaware business trust. Sterling owns all the common equity of SCT-VIII. The sole asset of SCT-VIII is the Junior Subordinated Debentures-VIII issued by Sterling. See Note 10 of Notes to Consolidated Financial Statements.
- (9) 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 10 of Notes to Consolidated Financial Statements.
- (10) 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 10 of Notes to Consolidated Financial Statements.
- (11) Lynnwood Financial Statutory Trust I ( LCT-I ) was organized in March 2003 as a Connecticut business trust. Sterling owns all the common equity of LCT-I. The sole asset of LCT-I is the Junior Subordinated Debentures-I issued by Lynnwood and assumed by Sterling. See Note 10 of Notes to Consolidated Financial Statements.
- (12) Lynnwood Financial Statutory Trust II ( LCT-II ) was organized in June 2005 as a Delaware business trust. Sterling owns all the common equity of LCT-II. The sole asset of LCT-II is the Junior Subordinated Debentures-II

issued by Lynnwood and assumed by Sterling. See Note 10 of Notes to Consolidated Financial Statements.

(13) 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.

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

## **Table of Contents**

(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) Mason-McDuffie Financial Corporation ( Mason-McDuffie ) conducts mortgage banking operations.

(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.

## **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, 2006, Sterling, including its subsidiaries, had 2,405 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 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*

## **Table of Contents**

*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 Golf Savings Bank is a Washington State-chartered savings bank. The deposits of both banks are insured by the FDIC. Sterling Savings Bank and Golf Savings Bank are 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.

*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



## **Table of Contents**

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 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.

**Table of Contents**

*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 and Golf Savings Bank are insured by the FDIC. As a result, they are 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.

*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

## **Table of Contents**

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.* 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: 1) merge the Bank Insurance Fund ( BIF ) and the Savings Association Insurance Fund ( SAIF ) into a new Deposit Insurance Fund ( DIF ); 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.

On March 31, 2006, the FDIC merged the BIF and SAIF to form the DIF. The DIF and FDIC insure deposits of Sterling Savings Bank and Golf Savings Bank up to the prescribed limits for each depositor. The FDIC maintains the DIF by assessing each depository institution an insurance premium. The amount of FDIC assessments paid by a DIF 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 DIF assessment rate currently ranges from 5 to 43 cents per \$100 of domestic deposits. The DIF assessment rate for Sterling Savings Bank and Golf Savings Bank, as well capitalized institutions, currently ranges from 5 to 7 cents per \$100 of domestic deposits. The FDIC may increase or decrease the assessment rate schedule up to three basis points from one quarter to the next. 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 subsidiaries, Sterling Savings Bank or Golf 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 1.28 cents per

\$100 of BIF-assessable deposits in 2006. The FDIC established the FICO assessment rate effective for the first quarter of 2007 at approximately 1.22 cents annually per \$100 of assessable deposits.

*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

## **Table of Contents**

limit the amount of dividends Sterling Savings Bank, Golf Savings Bank and certain other subsidiaries may pay without regulatory approval.

Federal bank regulatory agencies have the authority to prohibit Sterling Savings Bank and Golf Savings Bank from engaging in unsafe or unsound practices in conducting their business. The payment of dividends, depending on each bank's financial condition, could be deemed an unsafe or unsound practice. The ability of Sterling Savings Bank and Golf 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 and Golf Savings Bank are 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, 2006, Sterling Savings Bank and Golf 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 11 of Notes to Consolidated Financial Statements.

*State Law and Regulation.* Sterling Savings Bank and Golf Savings Bank, as Washington State-chartered institutions, are 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 and Golf 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 and Golf 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 or Golf Savings Bank's total assets. State law also regulates the types of loans Sterling Savings Bank and Golf Savings Bank can make. Without the Washington Supervisor's approval, Sterling Savings Bank and Golf Savings Bank cannot currently invest more than 10% of their 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. All of Golf Savings Bank's branches are located in the state of Washington. Sterling and its subsidiaries are also required to comply with applicable laws and regulations for activities in Arizona, California, Utah and Colorado.

## ***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-



## **Table of Contents**

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%.

*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.

## **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.

**Table of Contents**

**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

**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 its subsidiaries, including Sterling Savings Bank and Golf Savings Bank, although the principal source of Sterling's cash is dividends from Sterling Savings Bank and Golf Savings Bank. Sterling's right to participate in the assets of any subsidiary upon that 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 and Golf Savings Bank are also subject to restrictions under federal law that 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 or Golf Savings Bank to Sterling or any other affiliate are limited in amount to 10% of each 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 western United States, a significant portion of its total loan portfolio is originated in the western United States or secured by western United States 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.

## **Table of Contents**

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 commercial, consumer and construction lending while placing an increased emphasis on attracting greater volumes of retail deposits. Commercial, 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. Commercial 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 commercial, consumer and construction loans will offset higher levels of expense and losses on such loans.

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

Sterling's loans, with limited exceptions, are secured by real estate, marketable securities or corporate assets. A significant portion of Sterling's loans are residential construction loans. At December 31, 2006, approximately 32% of Sterling Savings Bank's total loan portfolio consisted of construction loans, approximately 32% of which were for speculative endeavors. Additionally, at December 31, 2006, 15% of Sterling Savings Bank's and Golf Savings Bank's loan portfolio consisted of multifamily residential and commercial property loans. A reduction in the demand for new construction or multifamily residential and commercial property loans or a decline in residential or commercial real estate values could have a negative impact on Sterling Savings Bank or Golf Savings Bank.

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. A decline in real estate values could have an adverse effect on Sterling's financial condition.

### **Sterling's earnings are significantly affected by the fiscal and monetary policies of governmental and regulatory agencies.**

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

## **Table of Contents**

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.

The OCC, Federal Reserve and FDIC have recently adopted final guidance entitled Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices. The guidance applies to institutions that have a high concentration of real estate and related loans in their portfolio. The guidance provides that such institutions may be required in the future to maintain higher capital ratios than other institutions with lower such concentrations. Based on the guidance as adopted, Sterling may be subject to increased regulatory oversight and guidance. While Sterling believes that it is and will continue to be well capitalized under current policies of the banking authorities, Sterling could become subject to higher capital requirements under the guidance which could result in lower earnings.

### **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 recently have been rising and could cause the amount of interest Sterling pays on deposits and borrowings to increase more quickly than the amount of interest Sterling receives on its loans, mortgage-related securities and investment securities. This could cause Sterling's 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.

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.



## **Table of Contents**

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 Sterling's market area.

### **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. For example, Sterling completed the acquisitions of Golf Savings Bank on July 5, 2006 and of FirstBank on November 30, 2006, and is expected to close the acquisition of Northern Empire on February 28, 2007. Risks associated with the integration of multiple acquisitions within a relatively short time period that may affect Sterling include, without limitation: the businesses might not be combined successfully, or such combination may take longer, be more difficult, time-consuming or costly to accomplish than expected; the expected growth opportunities and cost savings from the acquisitions may not be fully realized or may take longer to realize than expected; operating costs, customer losses and business disruption following the acquisitions, including adverse effects on relationships with employees, may be greater than expected; adverse governmental or regulatory policies may be enacted; the interest rate environment may further compress margins and adversely affect net interest income; results may be adversely affected by continued diversification of assets and adverse changes to credit quality; competition from other financial services companies in Sterling's markets could adversely affect operations; and an economic slowdown could adversely affect credit quality and loan originations.

Sterling may make opportunistic acquisitions of other banks or financial institutions from time to time that further its business strategy. 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 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 its 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, business and consumer loans as areas for increased lending emphasis. While increased lending diversification is expected to increase interest income, commercial real estate, business and consumer loans carry greater risk of payment default than residential real estate loans. As the volume of these loans increases, 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.**

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

## **Table of Contents**

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.

**Shares eligible for future sale could have a dilutive effect.**

Shares of Sterling common stock eligible for future sale, including those that may be issued in the acquisition of Northern Empire, in future acquisitions and any other offering of Sterling common stock for cash, could have a dilutive effect on the market for Sterling common stock and could adversely affect its market price. On July 25, 2006, Sterling filed a shelf registration statement on Form S-3 that provides for the issuance by Sterling of up to \$100 million in Sterling common stock and preferred stock. This will enable Sterling to offer additional shares of common and/or preferred stock for such consideration, on such terms and at such times as is determined by Sterling's board of directors.

There are 60,000,000 shares of Sterling common stock authorized, of which 42,042,740 shares were outstanding as of December 31, 2006. As a result of the merger of Sterling and Northern Empire, a maximum of 9,434,960 shares of Sterling common stock may be issued to Northern Empire shareholders.

**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**

Sterling owns the building in which its headquarters are located in Spokane, Washington. As of December 31, 2006, Sterling also owned 107 of its 166 full-service banking offices, while leasing the remainder of the properties. These facilities are located throughout Sterling's banking network, primarily in the Pacific Northwest. Additionally, Sterling operates 49 non-depository loan production offices throughout the western United States, the majority of which are leased. See Note 5 to the Consolidated Financial Statements.

**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, 2007, there were 42,200,432 shares of Sterling's common stock outstanding. As of January 31, 2007, Sterling's common stock was held by 2,092 shareholders of record, and the closing price as of that date for its common stock was \$33.17. 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, 2006:		
Fourth quarter	\$ 34.97	\$ 31.75
Third quarter	33.78	29.50
Second quarter	32.35	28.31
First quarter	29.91	24.50
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

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

<b>Date Paid</b>	<b>Per Share Amount</b>	<b>Total</b>
October 2005	\$ 0.050	\$ 1.7 million
January 2006	0.055	1.9 million
April 2006	0.060	2.1 million
July 2006	0.065	2.3 million
October 2006	0.070	2.6 million
January 2007	0.075	3.2 million

**Table of Contents**

**Performance Graph**

The following graph compares our cumulative total stockholder return since December 31, 2001 with the Russell 2000 Index and the SNL NASDAQ Bank Index. The graph assumes that the value of the investment in our common stock and each index (including reinvestment of dividends) was \$100.00 on December 31, 2001.

**Total Return Performance**

33

---

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

The following selected financial data is derived from Sterling's audited financial statements. Comparability among particular amounts may be affected by past acquisitions:

	Years Ended December 31,				
	2006	2005	2004	2003	2002
	(Dollars in thousands, except per share amounts)				
Interest income	\$ 550,855	\$ 387,811	\$ 319,761	\$ 214,727	\$ 197,313
Interest expense	(286,943)	(171,276)	(122,945)	(89,807)	(96,965)
Net interest income	263,912	216,535	196,816	124,920	100,348
Provision for losses on loans	(18,703)	(15,200)	(12,150)	(10,500)	(11,867)
Net interest income after provision for loss on loans	245,209	201,335	184,666	114,420	88,481
Non-interest income	69,340	59,569	47,799	33,735	29,080
Merger and acquisition costs	(454)	0	(4,835)	(792)	0
Amortization of core deposit intangibles	(2,405)	(2,222)	(2,222)	(262)	(644)
Goodwill litigation	(275)	(179)	(141)	(600)	(1,100)
Non-interest expenses	(203,239)	(167,880)	(141,172)	(92,910)	(79,199)
Income before income taxes	108,176	90,623	84,095	53,591	36,618
Income tax provision	(34,230)	(29,404)	(27,790)	(18,678)	(11,031)
Net income	\$ 73,946	\$ 61,219	\$ 56,305	\$ 34,913	\$ 25,587
Earnings per share:					
Basic(1)	\$ 2.03	\$ 1.77	\$ 1.66	\$ 1.45	\$ 1.19
Diluted(1)	2.01	1.75	1.62	1.42	1.16
Dividends declared per share	\$ 0.270	\$ 0.105	\$ 0.000	\$ 0.000	\$ 0.000
Weighted average shares outstanding:					
Basic(1)	36,423,095	34,633,952	33,931,509	23,980,113	21,496,008
Diluted(1)	36,841,866	35,035,029	34,708,794	24,590,172	22,115,723
Financial Ratios:					
Book value per share(1)	\$ 18.63	\$ 14.54	\$ 13.65	\$ 10.21	\$ 9.38
Return on average assets	0.88%	0.87%	0.88%	0.88%	0.80%
	13.0%	12.4%	13.2%	14.4%	13.9%

Return on average shareholders' equity					
Shareholders' equity to total assets	8.0%	6.7%	6.8%	5.9%	5.8%
Operating efficiency	61.9%	61.7%	60.7%	59.6%	62.5%
Net interest margin	3.30%	3.28%	3.32%	3.35%	3.37%
Nonperforming assets to total assets	0.11%	0.11%	0.20%	0.50%	0.59%
Statistical Data:					
Number of:					
Employees (full-time equivalents)	2,405	1,789	1,624	1,121	953
Full service branches	166	140	135	86	79

**Table of Contents**

	2006	2005	December 31, 2004	2003	2002
(Dollars in thousands)					
Balance Sheet Data:					
Total assets	\$ 9,828,652	\$ 7,558,928	\$ 6,942,224	\$ 4,279,321	\$ 3,507,021
Loans receivable, net	7,015,401	4,885,916	4,251,877	2,906,426	2,390,422
Mortgage-backed securities	1,687,672	1,960,582	2,036,920	983,736	743,610
Investments	225,974	167,957	167,665	89,448	86,558
Deposits	6,746,028	4,806,301	3,863,296	2,455,076	2,014,096
FHLB Seattle advances	1,308,617	1,443,462	1,635,933	1,026,031	874,515
Reverse repurchase agreements					
and funds purchased	616,354	611,676	780,012	363,137	249,769
Other borrowings	240,226	110,688	131,822	137,998	127,682
Shareholders' equity	783,416	506,685	469,844	250,348	203,656
Capital Ratios(2):					
Tier 1 leverage (to average assets) Sterling	8.7%	7.4%	N/A	N/A	N/A
Sterling Savings Bank	8.6%	7.2%	6.6%	7.4%	7.6%
Golf Savings Bank	6.9%	N/A	N/A	N/A	N/A
Tier I (to risk-weighted assets)					
Sterling	10.0%	9.5%	N/A	N/A	N/A
Sterling Savings Bank	9.7%	9.2%	9.7%	9.9%	10.0%
Golf Savings Bank	10.9%	N/A	N/A	N/A	N/A
Total (to risk-weighted assets)					
Sterling	11.1%	10.5%	N/A	N/A	N/A
Sterling Savings Bank	10.8%	10.2%	10.7%	10.9%	11.0%
Golf Savings Bank	11.6%	N/A	N/A	N/A	N/A

- (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 Financial Corporation did not have regulatory capital ratio requirements prior to its conversion to a bank holding company. Golf Savings Bank's capital ratios have not been disclosed for periods prior to Sterling's acquisition of Golf Savings Bank in July 2006.

**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 2006, Sterling achieved significant loan, deposit and earnings growth. The organic growth our banking teams achieved was complemented by several acquisitions. Increases in construction, commercial and residential lending were funded with growth in deposits. Net interest income increased primarily from growth in average loan balances. Growth in non-interest income was driven through fees and service charges, and mortgage banking operations. The Golf Savings Bank acquisition increased our presence in the mortgage banking business.

## **Table of Contents**

### **2006 Highlights**

Net income increased by 21 percent to a record \$73.9 million.

Total assets increased 30 percent year-over-year to a record \$9.83 billion. Sterling's organic growth represented 10 percent of total asset growth.

Loan originations of nearly \$5.0 billion reflect an increase of 28 percent over 2005.

Total loans receivable increased to a record \$7.02 billion, a 44 percent increase over 2005. Sterling's organic growth represented 21 percent of total loan growth.

Total deposits increased to a record \$6.75 billion, a 40 percent increase over 2005. Sterling's organic growth represented 18 percent of total deposit growth.

Net interest income increased to \$263.9 million, a 22 percent increase over 2005.

The number of transaction accounts increased to over 185,000, a 21 percent increase over 2005.

Asset quality remains solid and slightly stronger than regional peer averages.

### **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 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,



## **Table of Contents**

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, 2006.

*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 other factors. Available-for-sale securities are reported at fair value, with unrealized holding gains and losses reported in shareholders' equity as a separate component of other comprehensive income, net of applicable deferred income taxes.

Management evaluates investment securities for other than temporary declines in fair value on a quarterly basis. If the fair value of investment securities falls below their amortized cost and the decline is deemed to be other than temporary, the securities will be written down to current market value, resulting in a loss 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, 2006, 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.

Sterling's management performed an annual test of its goodwill and other intangible assets as of June 30, 2006, and concluded that the recorded values were not impaired. There are many assumptions and estimates underlying the determination of impairment. Another estimate using different but still reasonable assumptions could produce a significantly different result. Additionally, future events could cause management to conclude that Sterling's goodwill or other intangible assets are 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.

## **Table of Contents**

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

*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.

*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, 2006 and 2005**

*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, 2006 and 2005, NII was \$263.9 million and \$216.5 million, respectively, an increase of 21.9%. The increase in NII during 2006 compared to 2005 was mainly because the average loan balance increased by \$1.41 billion.

During the years ended December 31, 2006 and 2005, net interest margin was 3.30% and 3.28%, respectively, and net interest spread was 3.17% and 3.23%, 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. Average interest earning assets were greater relative to average interest bearing liabilities in 2006 versus 2005, resulting in an increase in net interest margin. The decrease in net interest spread was 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 interest spread and net interest margin:

	Years Ended December 31,							
	Average Balance(1)	2006 Interest Earned or Paid(2)	Average Yield or Cost(3)	Average Balance(1)	2005 Interest Earned or Paid(2)	Average Yield or Cost(3)	Average Balance(1)	2004 Interest Earned or Paid(2)
(Dollars in thousands)								
ing assets:								
cked securities	\$ 5,891,595	\$ 458,558	7.78%	\$ 4,482,012	\$ 296,306	6.61%	\$ 3,852,247	\$ 229,448
and cash	1,862,144	88,398	4.75%	1,948,435	88,682	4.55%	1,885,239	85,009
	233,611	3,899	1.67%	168,853	2,823	1.67%	190,934	5,304
-earning assets	7,987,350	550,855	6.90%	6,599,300	387,811	5.88%	5,928,420	319,761
earning assets	411,213			447,755			447,997	
e assets	\$ 8,398,563			\$ 7,047,055			\$ 6,376,417	
ing liabilities:								
ng	\$ 399,690	1,692	0.42%	\$ 419,137	1,340	0.32%	\$ 399,963	837
-bearing	706,631	0	0.00%	648,385	0	0.00%	546,128	0
MMDA	1,512,198	47,844	3.16%	1,158,270	22,272	1.92%	1,092,612	11,347
s	2,962,017	135,737	4.58%	2,041,122	68,378	3.35%	1,608,599	41,299
s	5,580,536	185,273	3.32%	4,266,914	91,990	2.16%	3,647,302	53,483
	2,125,620	101,670	4.78%	2,192,934	79,286	3.62%	2,200,229	69,462
-bearing	7,706,156	286,943	3.72%	6,459,848	171,276	2.65%	5,847,531	122,945
-bearing liabilities	122,435			93,992			101,134	
e liabilities	7,828,591			6,553,840			5,948,665	
e shareholders	569,972			493,215			427,752	
e liabilities and	\$ 8,398,563			\$ 7,047,055			\$ 6,376,417	
spread		\$ 263,912	3.17%		\$ 216,535	3.23%		\$ 196,816
margin			3.30%			3.28%		

age  
ng assets to  
est-bearing

103.65%

102.16%

- (1) Average balances are computed on a monthly basis.
- (2) Interest earned includes \$2.9 million, \$1.9 million and \$2.2 million of tax exempt interest for 2006, 2005 and 2004, 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 rates and volumes of interest-earning assets and interest-bearing liabilities. Volume refers to the dollar level of interest-earning assets and interest-bearing liabilities. The following table presents the composition of the change 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:

Volume changes in volume multiplied by comparative period rate;

Rate changes in rate multiplied by comparative period volume; and

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

	December 31, 2006				December 31, 2005			
	Increase (Decrease) Due to:				Increase (Decrease) Due to:			
	Volume	Rate	Rate/ Volume	Total	Volume	Rate	Rate/ Volume	Total
	(Dollars in thousands)							
Interest income on:								
Loans	\$ 93,832	\$ 52,392	\$ 16,028	\$ 162,252	\$ 37,508	\$ 25,226	\$ 4,124	\$ 66,858
Mortgage-backed securities	(3,927)	3,812	(169)	(284)	2,850	797	26	3,673
Investment and cash equivalents	1,083	(5)	(2)	1,076	(613)	(2,112)	244	(2,481)
Total interest income	90,988	56,199	15,857	163,044	39,745	23,911	4,394	68,050
Interest-bearing deposits:								
Time deposits	30,850	25,158	11,351	67,359	11,105	12,589	3,385	27,079
Savings and MMDA	6,806	14,374	4,392	25,572	682	9,662	581	10,925
Interest-bearing transaction accounts	49	293	10	352	40	442	21	503
Total deposits	37,705	39,825	15,753	93,283	11,827	22,693	3,987	38,507
Other borrowings	(2,434)	25,604	(786)	22,384	(933)	9,310	1,447	9,824
Total interest expense	35,271	65,429	14,967	115,667	10,894	32,003	5,434	48,331
Net interest income	\$ 55,717	\$ (9,230)	\$ 890	\$ 47,377	\$ 28,851	\$ (8,092)	\$ (1,040)	\$ 19,719

*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 \$18.7 million and \$15.2 million for the years ended December 31, 2006 and 2005, 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, construction and consumer loans, which have a somewhat higher loss profile than Sterling's historical mix of loans.



**Table of Contents**

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

	<b>Years Ended December 31, 2006                  2005 (Dollars in thousands)</b>	
Balance at January 1	\$ 55,483	\$ 49,362
Allowance for loan losses acquired	13,155	0
Provision for losses on loans	18,703	15,200
Amounts written off net of recoveries and other	(3,652)	(9,079)
Balance at December 31	\$ 83,689	\$ 55,483

At December 31, 2006, Sterling's total classified assets were 0.49% of total assets, compared with 0.79% of total assets at December 31, 2005. Nonperforming assets were 0.11% of total assets at December 31, 2006 and December 31, 2005. At December 31, 2006, Sterling's loan delinquency rate (60 days or more) as a percentage of total loans was 0.10%, compared with 0.18% at December 31, 2005. Improvements in the quality of the loan portfolio 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 December 31, 2006                  2005 (Dollars in thousands)</b>	
Fees and service charges	\$ 42,995	\$ 34,702
Mortgage banking operations	20,216	17,899
Bank-owned life insurance	5,020	5,914
Loan servicing fees	1,812	434
REO operations	176	477
Net gains (losses) on sales of securities	0	(57)
Gain (charge) related to early repayment of debt	(204)	645
Other non-interest expense	(675)	(445)
Total non-interest income	\$ 69,340	\$ 59,569

The increase in non-interest income for the years ended December 31, 2006 and December 31, 2005, was primarily due to an increase in fees and service charges, and income from mortgage banking operations. Fees and service charges for the year ended December 31, 2006 increased primarily due to the success of Sterling's Balance Shield program, an increase in debit card transactions, treasury management services, and merchant services. The increased income from mortgage banking operations was primarily a result of the acquisition of Golf Savings Bank, which

specializes in the origination and sale of residential mortgage loans into the secondary market. Gains on the sale of loans held for sale are recorded as income from mortgage banking operations.

During the year ended December 31, 2006, Sterling did not sell any investment securities or MBS, compared with sales resulting in a net loss of \$57,000 for the year ended December 31, 2005. The activity for both periods was a result of management's response to market conditions and portfolio management needs.

**Table of Contents**

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

	<b>As of and for the Years Ended December 31, 2006                  2005 (Dollars in millions)</b>	
Originations of residential mortgage loans	\$ 830.6	\$ 461.4
Originations of commercial real estate loans	131.0	218.4
Sales of residential loans	655.6	583.2
Sales of commercial real estate loans	54.9	125.5
Principal balances of residential loans serviced for others	621.6	606.7
Principal balances of commercial real estate loans serviced for others	1,622.8	814.2

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

	<b>Years Ended December 31, 2006                  2005 (Dollars in thousands)</b>	
Employee compensation and benefits	\$ 117,186	\$ 93,367
Occupancy and equipment	32,769	26,411
Data processing	14,180	12,678
Depreciation	10,280	8,627
Advertising	9,985	9,125
Travel and entertainment	5,955	4,522
Legal and accounting	2,478	3,134
Amortization of core deposit intangibles	2,405	2,222
Insurance	1,360	1,213
Merger and acquisition costs	454	0
Goodwill litigation costs	275	179
Other	9,046	8,803
Total	\$ 206,373	\$ 170,281

The increases in non-interest expenses were primarily due to continued company growth. Full-time equivalent employees increased year-over-year by 616 to 2,405 at December 31, 2006. The acquisitions of Golf Savings Bank, FirstBank and Mason-McDuffie added approximately 480 full-time equivalent employees.

*Income Tax Provision.* Sterling recorded federal and state income tax provisions of \$34.2 million and \$29.4 million for the years ended December 31, 2006 and 2005, respectively. The effective tax rates for these periods were 31.6% and 32.4%, with the decrease primarily reflecting Sterling's utilization of available tax credits.

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

*Net Interest Income.* NII for the years ended December 31, 2005 and 2004 was \$216.5 million and \$196.8 million, respectively. The 10.0% increase in NII was primarily due to growth in loan and MBS volumes. During the year ended December 31, 2005, average loans increased by \$629.8 million, an increase of 16.3% over 2004.

During the same periods, the net interest margins were 3.28% and 3.32%, respectively, and net interest spreads were 3.23% and 3.29%, respectively. The decreases in net interest margin and net interest spread were primarily due to the cost of funds increasing more rapidly than the yield in earning assets.

**Table of Contents**

*Provision for Losses on Loans.* 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 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)
	\$ 55,483	\$ 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. Total 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 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. Asset quality has been stable over the periods presented.

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

	<b>Years Ended 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
Bank-owned life insurance	5,914	4,340
Charge related to early repayment of debt	645	(238)
Real estate owned operations	477	(162)
Loan servicing fees	434	561
Net gains on sales of securities	(57)	4,571
Other non-interest expense	(445)	(120)
Total non-interest income	\$ 59,569	\$ 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.

During the year ended December 31, 2005, Sterling sold investments and MBS, resulting in net loss of \$57,000 compared to net gains of \$4.6 million for the year ended December 31, 2004. 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**

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

	<b>Years Ended December 31, 2005          2004 (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

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

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

The increases in non-interest expenses were primarily due to continued company growth. Full-time equivalent employees increased year-over-year by 165 to 1,789 at December 31, 2005.

*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.

## Financial Position

*Assets.* At December 31, 2006, Sterling's assets were \$9.83 billion, up 30.0% from \$7.56 billion at December 31, 2005. This growth was driven mainly by increases in the loan portfolio through both originations and acquisitions.

*Investments and MBS.* Sterling's investment and MBS portfolio at December 31, 2006 was \$1.91 billion, a decrease of \$214.9 million from the December 31, 2005 balance of \$2.13 billion. The decrease was due to principal repayments and maturities exceeding Sterling's purchases and acquisitions of securities. As of December 31, 2006, the investment and MBS portfolio had an unrealized loss of \$52.8 million versus an unrealized loss of \$54.1 million at December 31, 2005, with the fluctuation primarily due to interest rate movements.



**Table of Contents**

*Loans Receivable.* At December 31, 2006, net loans receivable were \$7.02 billion, up \$2.13 billion from \$4.89 billion at December 31, 2005. The increase was due to record loan originations and acquisitions, net of repayments.

*Bank-Owned Life Insurance ( BOLI ).* BOLI increased to \$139.2 million at December 31, 2006, from \$107.6 million at December 31, 2005. The increase was primarily due to the acquisition of FirstBank. 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.

*Goodwill and Other Intangible Assets.* Goodwill and other intangible assets increased to \$275.8 million at December 31, 2006, from \$130.3 million at December 31, 2005. See Note 6 of Notes to Consolidated Financial Statements.

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

	<b>December 31, 2006</b>		<b>December 31, 2005</b>	
	<b>Amount</b>	<b>%</b>	<b>Amount</b>	<b>%</b>
	<b>(Dollars in thousands)</b>			
Interest-bearing transaction	\$ 483,551	7.2	\$ 432,936	9.0
Noninterest-bearing transaction	834,140	12.4	673,934	14.0
Savings and MMDA	1,830,313	27.1	1,312,033	27.3
Time deposits	3,598,024	53.3	2,387,398	49.7
Total deposits	\$ 6,746,028	100.0	\$ 4,806,301	100.0
Annualized cost of deposits		3.32%		2.16%

Deposit growth was primarily in savings and time deposits, reflecting consumer demand, the use of brokered CD's as a cost competitive source of funds, and the deposit mix of acquired entities.

*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 meet deposit withdrawal requirements. At both December 31, 2006 and 2005, the total of such borrowings was \$2.17 billion. During 2006, FHLB advances decreased by approximately the same amount that other borrowings increased. Other borrowings increased from December 31, 2005 due to Sterling's wholly owned subsidiaries, Sterling Capital Trusts VII and VIII, issuing \$105.0 million of Trust Preferred Securities. Other borrowings also increased as a result of acquiring \$19.0 million of Trust Preferred Securities in the acquisition of Golf Savings Bank. See Liquidity and Capital Resources.

**Asset and Liability Management**

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

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

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

## **Table of Contents**

and its interest bearing liabilities, interest rate shock simulations of net interest income, and net portfolio value ( NPV ) simulation.

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

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, 2006. 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 or FNMA and estimated regular non-maturity deposit decay rates (the rate of withdrawals or transfers to higher-yielding products). Management believes these assumptions and estimates are reasonable, but there can be no assurance in this regard or that action undertaken to mitigate interest rate risk will have the desired effect. 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. While the GAP measurement has some limitations, including no assumptions regarding future asset or liability production and a static interest rate assumption (large changes may occur related to those items), the GAP represents the net asset or liability sensitivity at a point in time. A GAP measure could be significantly affected by external factors such as loan prepayments that

**Table of Contents**

occur faster or slower than assumed, early withdrawals of deposits, changes in the correlation of various interest-bearing instruments, competition or a rise or decline in interest rates.

	<b>0 to 3 Months</b>	<b>Over 3 Months to 1 Year</b>	<b>Maturity or Repricing Over 1 Year to 3 Years (Dollars in thousands)</b>	<b>Over 3 Years to 5 Years</b>	<b>Over 5 Years</b>	<b>Total</b>
Interest-earning assets:						
Mortgage loans and MBS:						
ARM, balloon mortgage loans and MBS	\$ 2,422,028	\$ 261,905	\$ 410,130	\$ 214,084	\$ 51,846	\$ 3,359,993
Fixed-rate mortgage loans and MBS	124,675	338,599	636,033	550,496	585,861	2,235,664
Loans held for sale	91,469	0	0	0	0	91,469
Total mortgage loans and MBS	2,638,172	600,504	1,046,163	764,580	637,707	5,687,126
Commercial and consumer loans:						
Consumer	282,406	161,054	314,791	159,138	120,941	1,038,330
Commercial	1,127,062	262,104	417,082	196,081	66,757	2,069,086
Total loans and MBS	4,047,640	1,023,662	1,778,036	1,119,799	825,405	8,794,542
Cash and investments	162,698	1,214	11,070	676	83,751	259,409
	4,210,338	1,024,876	1,789,106	1,120,475	909,156	9,053,951
Cash on hand and in banks	0	0	0	0	146,280	146,280
Other noninterest-earning assets	0	0	0	0	628,421	628,421
Total assets	\$ 4,210,338	\$ 1,024,876	\$ 1,789,106	\$ 1,120,475	\$ 1,683,857	\$ 9,828,652
Interest-bearing liabilities:						
Deposits:						
Time deposits	\$ 1,341,352	\$ 1,802,669	\$ 259,722	\$ 121,183	\$ 73,098	\$ 3,598,024
Checking accounts	45,912	95,462	83,631	73,544	1,019,142	1,317,691
MMDA	397,181	796,656	50,592	39,301	357,463	1,641,193
Passbook accounts	20,198	40,396	0	0	128,526	189,120
Total deposits	1,804,643	2,735,183	393,945	234,028	1,578,229	6,746,028
FHLB Seattle advances	1,021,006	36,063	108,019	81,792	61,737	1,308,617
Repurchase agreements and funds purchased	86,354	0	80,000	50,000	400,000	616,354
Other borrowings	0	0	0	0	236,772	236,772
	2,912,003	2,771,246	581,964	365,820	2,276,738	8,907,771

Total interest-bearing liabilities

Other noninterest-bearing liabilities

Shareholders' equity

Total liabilities and shareholders' equity

Net gap

Cumulative gap

Cumulative gap to total assets

0	0	0	0	137,465	137,465
0	0	0	0	783,416	783,416

\$ 2,912,003	\$ 2,771,246	\$ 581,964	\$ 365,820	\$ 3,197,619	\$ 9,828,652
--------------	--------------	------------	------------	--------------	--------------

\$ 1,298,335	\$ (1,746,370)	\$ 1,207,142	\$ 754,655	\$ (1,513,762)	\$ 0
--------------	----------------	--------------	------------	----------------	------

\$ 1,298,335	\$ (448,035)	\$ 759,107	\$ 1,513,762	\$ 0	\$ 0
--------------	--------------	------------	--------------	------	------

13.21%	(4.56)%	7.72%	15.40%	0.00%	0.00%
--------	---------	-------	--------	-------	-------

ALCO uses interest rate shock simulations of net interest income to measure the effect of changes in interest rates on the net interest income for Sterling over a 12 month period. This simulation consists of measuring the change in net interest income over the next 12 months from a base case scenario when rates are shocked, in a parallel fashion, up and down 100, 200, and 300 basis points. The base case uses the assumption of the existing balance sheet and existing interest rates to simulate the base line of net interest income over the next 12 months for the simulation. The simulation requires numerous assumptions, including relative levels of market interest rates, instantaneous and parallel shifts in the yield curve, loan prepayments and reactions of depositors to changes in interest rates, and should not be relied upon as being indicative of actual or future results. Further, the analysis does not contemplate

**Table of Contents**

actions Sterling may undertake in response to changes in interest rates and market conditions. The results of this simulation as of December 31, 2006 and 2005 are included in the following table:

	<b>December 31,</b>	
	<b>2006</b>	<b>2005</b>
	<b>%</b>	<b>%</b>
<b>Change in Interest Rate in Basis Points (Rate Shock)</b>	<b>Change in NII</b>	<b>% Change in NII</b>
+200	(1.5)	(4.6)
+100	(0.8)	(2.4)
Static	0.0	0.0
-100	(0.4)	(0.5)
-200	(1.6)	(5.2)

ALCO uses NPV simulation analysis to measure risk in the balance sheet that might not be taken into account in the net interest income simulation analysis. Whereas net interest income simulation highlights exposure over a relatively short time period of 12 months, NPV simulation analysis incorporates all cash flows over the estimated remaining life of all balance sheet positions. The NPV simulation analysis of the balance sheet, at a point in time, is defined as the discounted present value of asset cash flows minus the discounted value of liability cash flows. The discount rates that are used represent an assumption for the current market rates of each group of assets and liabilities. The difference between the present value of the asset and liability represents the NPV. As with net interest income, this is used as the base line to measure the change in NPV when interest rates are shocked, in a parallel fashion, up and down 100, 200, and 300 basis points. As with the net interest income simulation model, NPV simulation analysis is based on key assumptions about the timing and variability of balance sheet cash flows. However, because the simulation represents much longer time periods, inaccuracy of assumptions may increase the variability of outcomes within the simulation. It also does not take into account actions management may undertake in response to anticipated changes in interest rates. The results of this simulation at December 31, 2006 and 2005 are included in the following table:

	<b>At December 31,</b>	
	<b>2006</b>	<b>2005</b>
	<b>%</b>	<b>%</b>
<b>Change in Interest Rate in Basis Points (Rate Shock)</b>	<b>Change in NPV</b>	<b>% Change in NPV</b>
+200	(5.0)	(7.1)
+100	(1.5)	(3.5)
Static	0.0	0.0
-100	(4.6)	(5.9)
-200	(17.9)	(25.5)

Sterling occasionally enters into customer-related financial derivative transactions primarily consisting of interest rate swaps. Risk exposure from customer positions is managed through transactions with other dealers. As of December 31, 2006, Sterling has not entered into asset/liability related derivative transactions as part of managing its interest rate risk. However, Sterling continues to consider derivatives, including interest rate swaps, caps and floors, as a viable alternative in the asset and liability management process.

## **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 40% to \$6.75 billion at December 31, 2006 from \$4.81 billion at December 31, 2005, mainly due to increases of \$1.21 billion in time deposits. This increase in time deposits primarily reflected Sterling's use of funds as a cost competitive source to generate loan growth, in addition to time deposits added as a result of Sterling's acquisitions.

Sterling Savings Bank and Golf Savings Bank actively manage their liquidity in an effort to maintain an adequate margin over the level necessary to support expected and potential loan fundings and deposit withdrawals.

## **Table of Contents**

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, 2006, net cash used in investing activities was \$757.1 million, which consisted mainly of funding of loans, partially offset by cash inflows from loan principal repayments and runoff in the MBS portfolio. During the year, net cash provided by financing activities was \$693.2 million, which consisted primarily of net inflows from deposit accounts.

Sterling Savings Bank's credit line with FHLB Seattle provides for borrowings up to a percentage of its total assets, subject to collateralization requirements. FHLB Seattle advances are collateralized with securities, and commercial and residential loans. At December 31, 2006, this credit line represented a total borrowing capacity of \$2.04 billion, of which \$734.9 million was available. The FHLB Seattle has been undergoing organizational and operational changes for more than two years pursuant to a written agreement with its regulator, the Federal Housing Finance Board (Finance Board). During this time, FHLB Seattle continued to provide Sterling with ready sources of liquidity. Based on FHLB Seattle's recent earnings and capital position, the Finance Board permitted the FHLB Seattle to resume dividend payments in December 2006, and on January 12, 2007, terminated the written agreement. Also, the Standard & Poor's rating outlook for FHLB Seattle improved to stable.

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, 2006, Sterling Savings Bank had \$616.4 million in outstanding borrowings under reverse repurchase agreements and had securities available for additional secured borrowings of approximately \$193.0 million. The use of reverse repurchase agreements may expose Sterling to certain risks not associated with other borrowings, including IRR and the possibility that additional collateral may have to be provided if the market value of the pledged collateral declines. 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 \$21.1 million and \$15.7 million at December 31, 2006 and 2005, respectively. At December 31, 2006 and 2005, Sterling had an investment of \$175.1 million and \$110.1 million, respectively, in the preferred stock of Sterling Savings Bank, and \$512.6 million and \$294.6 million, respectively, in the common stock of Sterling Savings Bank. The increase in the preferred stock investment reflects proceeds from Trust Preferred Securities issued by Sterling Capital Trusts VII and VIII. The increase in the investment in the common stock of Sterling Savings Bank reflects Sterling's acquisition and merger of FirstBank Northwest into Sterling Savings Bank, as well as an investment of \$52.2 million that was funded with borrowings, and a dividend from Golf Savings Bank of \$32.2 million as a result of asset and liability transfers following the closing of the acquisition by Sterling. Also during 2006, Sterling invested \$1.5 million in the common stock of Golf Savings Bank. Sterling received cash dividends from Sterling Savings Bank of \$24.3 million and \$11.6 million during the twelve months ended December 31, 2006, and December 31, 2005, respectively. 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, capital requirements, and capital distribution regulations.



**Table of Contents****Off-Balance Sheet Arrangements and Aggregate Contractual Obligations**

The following table represents Sterling's on-and-off-balance sheet aggregate contractual obligations to make future payments as of December 31, 2006:

		Payments Due by Period			
		Less Than	1 to	Over	More Than
	Total	1 Year	3 Years	5 Years	5 Years
(Dollars in thousands)					
Long-term debt(1)	\$ 2,165,197	\$ 890,114	\$ 311,615	\$ 699,224	\$ 264,244
Capital lease obligations	0	0	0	0	0
Operating leases	86,352	11,703	20,249	14,982	39,418
Purchase obligations(2)	41,161	18,157	15,336	7,668	0
Other long-term liabilities(3)	34,854	478	1,528	1,940	30,908
Total	\$ 2,327,564	\$ 920,452	\$ 348,728	\$ 723,814	\$ 334,570

(1) Excludes interest payments. See Notes 8 – 10 of Notes to Consolidated Financial Statements.

(2) Excludes recurring accounts payable amounts due in the first quarter of 2007.

(3) Includes amounts associated with retirement and benefit plans and other compensation arrangements. The amounts represent the total future potential payouts assuming all current participants become fully vested in their respective plans or arrangements. See Note 17 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 future effect.

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

mortgage banking operations in future periods. At December 31, 2006, Sterling did not have any loans locked with investors under mandatory delivery programs, nor hold any offsetting forward sale agreements on MBS. As of December 31, 2006, Sterling had entered into best efforts forward commitments to sell \$142.6 million of mortgage loans.

Rate lock commitments to borrowers and best-effort loan delivery commitments from investors are off-balance-sheet commitments that are considered to be derivatives. Sterling accounts for these commitments by recording their estimated fair value on its balance sheet. As of December 31, 2006, Sterling recorded an asset of approximately \$482,000 for the estimated fair value of rate locks issued and a liability of approximately \$482,000 for the estimated fair value of delivery commitments received. As of December 31, 2005, Sterling had loans subject to rate locks under a mandatory delivery program and held off-setting forward sale agreements for MBS. Correspondingly, as of December 31, 2005, Sterling recorded an asset of \$147,000 for the fair value of rate locks and a liability of \$25,000 for the fair value of forward sale agreements.

Sterling enters into interest rate swap derivative contracts with customers. The IRR on these contracts is offset by entering into comparable dealer swaps. These contracts are carried at fair value.

## **Table of Contents**

### **Capital**

Sterling's total shareholders' equity was \$783.4 million at December 31, 2006, compared with \$506.7 million at December 31, 2005. The increase in total shareholders' equity was primarily due to the retention of earnings, and issuance of Sterling's common stock in connection with the acquisition of Golf Savings Bank and FirstBank. Shareholders' equity was 8.0% of total assets at December 31, 2006, compared with 6.7% at December 31, 2005.

At December 31, 2006 and 2005, Sterling had an unrealized loss of \$52.8 million and \$54.1 million, respectively, on investment securities and MBS classified as available for sale. The change since December 31, 2005 reflects the increase in the market value of the MBS portfolio. 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 10 of Notes to Consolidated Financial Statements.

Sterling, Sterling Savings Bank and Golf Savings Bank are required by applicable regulations to maintain certain minimum capital levels. Sterling's management intends to enhance the capital resources and regulatory capital ratios of Sterling and its banking subsidiaries through the retention of an adequate amount of earnings and the management of the level and mix of assets, although there can be no assurance in this regard. At December 31, 2006, each of the companies exceeded all such regulatory capital requirements and were well capitalized pursuant to such regulations.

### **Goodwill Litigation**

In May 1990, Sterling initiated a lawsuit against the U.S. Government with respect to the loss of the goodwill treatment and other matters relating to Sterling's past acquisitions of troubled thrift institutions (the Goodwill Litigation ). In the Goodwill Litigation, Sterling is seeking damages for, among other things, breach of contract and deprivation of property without just compensation. In September 2002, the U.S. Court of Federal Claims granted Sterling Savings Bank's motion for summary judgment as to liability on its contract claim, holding that the U.S. Government owed contractual obligations to Sterling with respect to the company's acquisition of three failing regional thrifts during the 1980s and had breached its contracts with Sterling. On March 31, 2005, a hearing was held in the U.S. Court of Federal Claims on the U.S. Government's motion to reconsider part of the September 2002 liability judgment, relating to Sterling's acquisition of the largest of the three thrifts it acquired, Central Evergreen Savings & Loan. Sterling opposed the motion.

On August 30, 2006, the Court of Federal Claims granted the U.S. Government's motion to reconsider, and held that the U.S. Government was not liable for breach of the contract for Sterling's acquisition of Central Evergreen Savings and Loan. The Court set a trial date of June 25, 2007 to determine what amount, if any, the U.S. Government must pay in damages for its breach of the contracts for the acquisition of the two smaller thrifts, Lewis Federal Savings & Loan and Tri-Cities Savings & Loan. The ultimate outcome of the Goodwill Litigation cannot be predicted with certainty. The U.S. Government will likely appeal any award of damages in favor of Sterling, and Sterling may appeal the adverse ruling as to Central Evergreen Savings & Loan. Because of the effort required to bring the case to conclusion, Sterling will likely continue to incur legal expenses as the case progresses.

### **New Accounting Policies**

In September 2006, the Emerging Issues Task Force ( EITF ) reached a consensus on Issue No. 06-4, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements. Under the provisions of EITF Issue No. 06-4, Sterling will recognize the amount, if any, that is owed current or former employees under split dollar BOLI. Also in September, the EITF Issued No. 06-5, Accounting for Purchases of Life Insurance Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4, Accounting for Purchases of Life Insurance. EITF Issue No. 06-5 requires recognition of various other amounts under insurance contracts. EITF 06-4 is effective January 1, 2008 and EITF 06-5 is effective January 1, 2007. Sterling is currently assessing the potential impact of these standards.

## **Table of Contents**

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

In July 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes ( FIN No. 48 ). This pronouncement requires a certain methodology for measuring and reporting uncertain tax positions, as well as disclosures. Adoption may result in a cumulative adjustment to income tax liabilities and retained earnings, if applicable. FIN No. 48 will be effective for Sterling as of January 1, 2007, and is not expected to have a material effect on Sterling.

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

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

## **Effects of Inflation and Changing Prices**

A financial institution has an asset and liability structure that is interest-rate sensitive. As a holder of monetary assets and liabilities, an 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.

**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,

**Table of Contents**

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.

There were no changes in internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)), during our fourth fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**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 Rules 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, 2006.

For purposes of evaluating internal controls over financial reporting, management determined that the internal controls over financial reporting of Lynnwood and FirstBank, which Sterling acquired in July and November of 2006, respectively, would be excluded from the internal control assessment as of December 31, 2006, as permitted by the rules and regulations of the Securities and Exchange Commission. Lynnwood's and FirstBank's total assets were 3% and 10% of total consolidated assets, respectively. Since being acquired, Lynnwood's and FirstBank's net interest income represented 2% and less than 1% of Sterling's consolidated net interest income, respectively.

Management's assessment of the effectiveness of its internal control over financial reporting as of December 31, 2006 has been attested to by BDO Seidman, LLP, the independent registered public accounting firm that audited the financial statements included in Sterling's annual report on form 10-K, as stated in their report which 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 ( Company ) maintained effective internal control over financial reporting as of December 31, 2006, 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.

As described in Management's Report on Internal Control Over Financial Reporting, management's assessment of and conclusion on the effectiveness of internal control over financial reporting did not include the internal controls of Lynnwood Financial Group, Inc ( Lynnwood ) and FirstBank NW Corp ( FirstBank ), which the Company acquired in July and November of 2006, respectively. Lynnwood's and FirstBank's total assets were 3% and 10%, respectively, of total consolidated assets as of December 31, 2006. For the year ended December 31, 2006, Lynnwood's and FirstBank's net interest income was 2% and less than 1%, respectively, of consolidated net interest income. Our audit of the effectiveness of the Company's internal control over financial reporting also did not include an evaluation of the internal control over financial reporting of FirstBank and Lynnwood.

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, 2006, 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, 2006, 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, 2006 and

**Table of Contents**

2005, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2006, of Sterling Financial Corporation and our report dated February 28, 2007, expressed an unqualified opinion on those consolidated financial statements.

BDO Seidman, LLP  
Spokane, Washington  
February 28, 2007

**Item 9B. *Other Information***

None.

**PART III**

**Item 10. *Directors, Executive Officers and Corporate Governance***

In response to this Item, the information set forth in Sterling's Proxy Statement for its 2007 annual meeting of shareholders, 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 "Information Concerning the Board of Directors and Its Committees" "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 "Executive Compensation," "Personnel Committee Report," and "Personnel Committee Interlocks and Insider Participation" 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 Management and Certain Beneficial Owners" and "Equity Compensation Plan Information" is incorporated herein by reference.

**Item 13. *Certain Relationships and Related Transactions, and Director Independence***

In response to this Item, the information set forth in the Proxy Statement under the headings "Interest of Directors, Officers and Others in Certain Transactions" and "Corporate Governance" "Affirmative Determinations Regarding Director Independence" 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," "Independent Public

Accounting Firm's Fees, and Pre-Approval of Audit and Non-Audit Services 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

By /s/ Harold B. Gilkey

**Harold B. Gilkey**

Chairman of the Board, Chief Executive Officer

February 28, 2007

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.

By /s/ Harold B. Gilkey

**Harold B. Gilkey**

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

February 28, 2007

By /s/ William W. Zuppe

**William W. Zuppe**

President, Chief Operating Officer, Director

February 28, 2007

By /s/ Daniel G. Byrne

**Daniel G. Byrne**

Executive Vice President, Assistant Secretary and  
Principal Financial Officer

February 28, 2007

By /s/ Robert G. Butterfield

**Robert G. Butterfield**

Vice President, Controller and Principal Accounting Officer

February 28, 2007

**Table of Contents**

February 28, 2007

By /s/ Rodney W. Barnett

**Rodney W. Barnett**, Director

February 28, 2007

By /s/ Donald N. Bauhofer

**Donald N. Bauhofer**, Director

February 28, 2007

By /s/ William L. Eisenhart

**William L. Eisenhart**, Director

February 28, 2007

By /s/ James P. Fugate

**James P. Fugate**, Director

By

**Robert D. Larrabee**, Director

February 28, 2007

By /s/ Donald J. Lukes

**Donald J. Lukes**, Director

February 28, 2007

By /s/ Michael F. Reuling

**Michael F. Reuling**, Director

58

---

**Table of Contents**

<b>Exhibit No.</b>	<b>Exhibit Index</b>
2.1	Agreement and Plan of Merger by and between Sterling and Northern Empire Bancshares dated as of September 17, 2006. Filed as Exhibit 2.1 to Sterling's current report on Form 8-K filed September 18, 2006 and incorporated by reference herein.
2.2	Agreement and Plan of Merger by and between Sterling and FirstBank NW Corp. dated as of June 4, 2006. Filed as Appendix A to Sterling's Registration Statement on Form S-4 dated August 31, 2006 and incorporated by reference herein.
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	Credit Agreement by and between Sterling and Wells Fargo Bank, National Association, entered into on August 21, 2006 and dated as of August 4, 2006, and First Amendment thereto dated as of August 29, 2006. Filed as Exhibit 10.1 to Sterling's Quarterly Report on Form 10-Q dated November 9, 2006 and incorporated by reference herein.
10.2	Sterling Financial Corporation 2003 Long-Term Incentive Plan. Filed as Exhibit A to Sterling's Proxy Statement in connection with the Annual Meeting of Shareholders held on April 22, 2003, and incorporated by reference herein.
10.3	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.
10.4	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.
10.5	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.
10.6	Sterling Savings Bank Deferred Compensation Plan, effective date April 1, 2006. Filed herewith.
10.7	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.
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.
32.1	

Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. Furnished herewith.

32.2 Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. Furnished herewith.

E-1

---



**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, 2006 and 2005, and the related consolidated statements of income, comprehensive income, changes in shareholders equity, and cash flows for each of the three years in the period ended December 31, 2006. 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, 2006 and 2005, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2006, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 12 to the consolidated financial statements, the Company adopted Statement of Financial Accounting Standards No. 123(R), *Share-Based Payment*, as of January 1, 2006.

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, 2006, 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 February 28, 2007, expressed an unqualified opinion thereon.

BDO Seidman, LLP  
Spokane, Washington  
February 28, 2007

---

**Table of Contents****Sterling Financial Corporation****Consolidated Balance Sheets  
December 31, 2006 and 2005**

	2006	2005
	(Dollars in thousands)	
ASSETS:		
Cash and cash equivalents:		
Interest bearing	\$ 13,846	\$ 9,400
Noninterest bearing and vault	164,719	121,907
Total cash and cash equivalents	178,565	131,307
Restricted cash	1,150	862
Investments and mortgage-backed securities ( MBS ):		
Available for sale	1,820,583	2,076,615
Held to maturity	93,063	51,924
Loans receivable, net	7,015,401	4,885,916
Loans held for sale	91,469	7,894
Accrued interest receivable	55,519	35,805
Real estate owned, net	4,052	779
Office properties and equipment, net	93,796	82,432
Bank-owned life insurance ( BOLI )	139,206	107,649
Goodwill	247,244	112,707
Other intangible assets	28,570	17,625
Mortgage servicing rights, net	7,335	5,430
Prepaid expenses and other assets, net	52,699	41,983
Total assets	\$ 9,828,652	\$ 7,558,928
LIABILITIES:		
Deposits	\$ 6,746,028	\$ 4,806,301
Advances from Federal Home Loan Bank of Seattle ( FHLB Seattle )	1,308,617	1,443,462
Securities sold subject to repurchase agreements and funds purchased	616,354	611,676
Other borrowings	240,226	110,688
Cashiers checks issued and payable	18,144	5,483
Borrowers' reserves for taxes and insurance	2,348	1,527
Accrued interest payable	39,863	18,169
Accrued expenses and other liabilities	73,656	54,937
Total liabilities	9,045,236	7,052,243
Commitments and contingencies		
SHAREHOLDERS' EQUITY:		
Preferred stock, \$1 par value; 10,000,000 shares authorized; no shares issued and outstanding	0	0

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

Common stock, \$1 par value; 60,000,000 shares authorized; 42,042,740 and 34,855,549 shares issued and outstanding	42,043	34,856
Additional paid-in capital	590,218	385,353
Accumulated other comprehensive loss:		
Unrealized losses on investments and MBS available-for-sale, net of deferred income taxes of \$19,531 and \$20,021	(33,350)	(34,219)
Retained earnings	184,505	120,695
Total shareholders' equity	783,416	506,685
Total liabilities and shareholders' equity	\$ 9,828,652	\$ 7,558,928

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

F-2

---

**Table of Contents****Sterling Financial Corporation****Consolidated Statements of Income  
For the Years Ended December 31, 2006, 2005 and 2004**

**2006                      2005                      2004**  
**(Dollars in thousands, except per share amounts)**

Interest income:			
Loans	\$ 458,558	\$ 296,306	\$ 229,448
MBS	88,398	88,682	85,009
Investments and cash equivalents	3,899	2,823	5,304
 Total interest income	 550,855	 387,811	 319,761
 Interest expense:			
Deposits	185,273	91,990	53,483
Short-term borrowings	35,979	35,255	23,787
Long-term borrowings	65,691	44,031	45,675
 Total interest expense	 286,943	 171,276	 122,945
 Net interest income	 263,912	 216,535	 196,816
Provision for losses on loans	(18,703)	(15,200)	(12,150)
 Net interest income after provision for losses on loans	 245,209	 201,335	 184,666
 Non-interest income:			
Fees and service charges	42,995	34,702	32,692
Mortgage banking operations	20,216	17,899	6,155
Loan servicing fees	1,812	434	561
Net gains (losses) on sales of securities	0	(57)	4,571
Real estate owned and other collateralized assets operations	176	477	(162)
BOLI	5,020	5,914	4,340
Gain (charge) related to early repayment of debt	(204)	645	(238)
Other non-interest expense	(675)	(445)	(120)
 Total non-interest income	 69,340	 59,569	 47,799
 Non-interest expenses (Note 18)	 206,373	 170,281	 148,370
 Income before income taxes	 108,176	 90,623	 84,095
 Income tax benefit (provision)			
Current	(41,797)	(23,192)	(19,030)
Deferred	7,567	(6,212)	(8,760)
 Total tax provision	 (34,230)	 (29,404)	 (27,790)

Net income	\$	73,946	\$	61,219	\$	56,305
Earnings per share    basic	\$	2.03	\$	1.77	\$	1.66
Earnings per share    diluted	\$	2.01	\$	1.75	\$	1.62
Weighted average shares outstanding    basic		36,423,095		34,633,952		33,931,509
Weighted average shares outstanding    diluted		36,841,866		35,035,029		34,708,794

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

F-3

---

**Table of Contents**

**Sterling Financial Corporation**

**Consolidated Statements of Comprehensive Income  
For the Years Ended December 31, 2006, 2005 and 2004**

	<b>2006</b>	<b>2005</b>	<b>2004</b>
	<b>(Dollars in thousands)</b>		
Net income	\$ 73,946	\$ 61,219	\$ 56,305
Other comprehensive income (loss):			
Change in unrealized gains or losses on investments and MBS available for sale, net of reclassification adjustments	1,359	(39,303)	8,437
Less deferred income tax benefit (provision)	(490)	14,554	(2,714)
Net other comprehensive income (loss)	869	(24,749)	5,723
Comprehensive income	\$ 74,815	\$ 36,470	\$ 62,028

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

F-4

---

**Table of Contents****Sterling Financial Corporation****Consolidated Statements of Changes in Shareholders' Equity  
For the Years Ended December 31, 2006, 2005 and 2004**

	<b>Common Stock</b>		<b>Additional Paid-In</b>	<b>Other Comprehensive Income (Loss)</b>	<b>Retained Earnings</b>	<b>Total Shareholders' Equity</b>
	<b>Shares</b>	<b>Amount</b>	<b>Capital (Dollars in thousands)</b>			
Balance, January 1, 2004	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)	0
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
Balance, December 31, 2004	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)			0
Cash dividends declared					(3,657)	(3,657)
Cash paid for fractional shares	(550)		(14)			(14)
Tax benefit of stock options			631			631
Net income					61,219	61,219
Balance, December 31, 2005	34,855,549	34,856	385,353	(34,219)	120,695	506,685

Shares issued upon exercise of stock options	483,183	483	5,883			6,366
Shares issued for business combinations	6,645,882	6,646	194,479			201,125
Shares issued for 401(k) match and direct stock purchases	58,126	58	1,617			1,675
Change in unrealized gain or loss on investments and MBS available for sale, net of income tax				869		869
Cash dividends declared					(10,136)	(10,136)
Stock option compensation expense			182			182
Tax benefit of stock options			2,704			2,704
Net income					73,946	73,946
<b>Balance, December 31, 2006</b>	42,042,740	\$ 42,043	\$ 590,218	\$ (33,350)	\$ 184,505	\$ 783,416

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



**Table of Contents****Sterling Financial Corporation****Consolidated Statements of Cash Flows  
For the Years Ended December 31, 2006, 2005 and 2004**

	<b>2006</b>	<b>2005</b>	<b>2004</b>
	<b>(Dollars in thousands)</b>		
Cash flows from operating activities:			
Net income	\$ 73,946	\$ 61,219	\$ 56,305
Adjustments to reconcile net income to net cash provided by operating activities:			
Provisions for losses on loans and real estate owned	18,873	15,223	12,155
Stock dividends on FHLB Seattle stock	0	(303)	(1,994)
Accretion of deferred gain on sale of building	(320)	0	0
Net gain on sales of loans, investments and MBS	(10,545)	(10,219)	(7,093)
Stock based compensation	182	0	0
Excess tax benefit from stock based compensation	(2,704)	0	0
Stock issuances relating to 401(k) match	1,582	0	0
Other gains and losses	1,910	(103)	117
Gain related to early repayment of debt	0	(645)	0
Increase in cash surrender value of BOLI	(5,020)	(5,914)	(4,340)
Depreciation and amortization	19,253	20,063	14,289
Deferred income tax (provision) benefit	7,567	(6,212)	8,760
Change in:			
Accrued interest receivable	(11,259)	(8,326)	(4,437)
Prepaid expenses and other assets	(11,722)	17,375	1,955
Cashiers checks issued and payable	11,529	2,270	(14,411)
Accrued interest payable	19,684	3,327	4,505
Accrued expenses and other liabilities	(11,767)	10,734	(7,934)
Proceeds from sales of loans originated for sale	630,185	182,538	205,899
Loans originated for sale	(620,214)	(178,718)	(203,378)
Net cash provided by operating activities	111,160	102,309	60,398
Cash flows from investing activities:			
Change in restricted cash	(288)	419	223
Loans funded and purchased	(4,235,924)	(3,732,692)	(3,102,775)
Loan principal received	3,066,906	2,619,152	2,308,746
Proceeds from sales of other loans	90,802	472,682	0
Purchase of investments securities	(60,165)	(17,152)	(239,438)
Proceeds from maturities of investments securities	21,685	2,604	226,535
Proceeds from sales of investments securities	0	14,844	97,597
Cash and cash equivalents acquired as part of mergers	82,403	0	44,031
Purchase of BOLI	0	(10,000)	0
Purchase of mortgage-backed securities	0	(471,715)	(1,312,581)
Principal payments on MBS	270,291	385,126	353,175
Proceeds from sales of MBS	0	115,837	537,672

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

Purchase of office properties and equipment	(15,120)	(12,901)	(10,623)
Sale of office properties and equipment	21,015	268	0
Improvements and other changes to real estate owned	(11)	(331)	241
Proceeds from sales of real estate owned	1,353	4,104	6,705
Net cash used in investing activities	(757,053)	(629,755)	(1,090,492)
Cash flows from financing activities:			
Net change in transaction and savings deposits	\$ 249,122	\$ 302,593	\$ 139,333
Proceeds from issuance of time deposits	3,912,383	2,749,173	2,050,289
Payments for maturing time deposits	(3,451,067)	(2,195,593)	(1,819,944)
Interest credited to deposits	164,185	86,832	50,399
Advances from FHLB Seattle	2,316,797	1,204,777	1,401,062
Repayment of advances from FHLB Seattle	(2,519,021)	(1,395,513)	(1,150,896)
Net change in securities sold subject to repurchase agreements and funds purchased	(83,137)	(168,336)	416,875
Proceeds from other borrowings	130,000	0	0
Repayment of other borrowings	(27,200)	(19,000)	(36,995)
Payments for fractional shares	0	(14)	(240)
Proceeds from stock purchases	6,459	3,411	7,083
Excess tax benefit from stock based compensation	2,704	0	0
Deferred financing costs	0	(75)	0
Cash dividends paid to shareholders	(8,895)	(1,736)	0
Other	821	(953)	836
Net cash provided by financing activities	693,151	565,566	1,057,802
Net change in cash and cash equivalents	47,258	38,120	27,708
Cash and cash equivalents, beginning of year	131,307	93,187	65,479
Cash and cash equivalents, end of year	\$ 178,565	\$ 131,307	\$ 93,187
Supplemental disclosures:			
Cash paid during the period for:			
Interest	\$ 265,249	\$ 167,949	\$ 116,326
Income taxes	41,273	11,377	17,427
Noncash financing and investing activities:			
Loans converted into real estate owned	4,326	2,271	3,858
Common stock issued for business combinations	201,125	0	145,940
Common stock cash dividend accrued	3,154	1,921	0
Common stock dividend	0	0	62,467
Common stock split, effected as dividend	0	11,553	0
Deferred gains on sales of branches	10,319	0	0

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

**Table of Contents**

**Sterling Financial Corporation**

**Summary of Significant Accounting Policies  
For the Years Ended December 31, 2006, 2005 and 2004**

**Business**

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

Sterling provides personalized, quality financial services and Perfect Fit banking products to its customers consistent with its Hometown Helpful philosophy. Sterling believes that its dedication to personalized service has enabled it to grow both its retail deposit base and its lending portfolio in the western United States. With \$9.83 billion in total assets at December 31, 2006, Sterling originates loans and attracts Federal Deposit Insurance Corporation ( FDIC ) insured deposits from the general public through 166 financial service centers located in Washington, Oregon, Idaho and Montana. In addition, Sterling originates loans through Golf Savings Bank and Action Mortgage residential loan production offices and through INTERVEST commercial real estate lending offices throughout the western United States. Sterling also markets fixed income and equity products, mutual funds, fixed and variable annuities and other financial products through Harbor Financial service representatives located throughout Sterling's financial service center network.

**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

F-7

---

**Table of Contents**

**Sterling Financial Corporation**

**Summary of Significant Accounting Policies (Continued)**

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.

**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, 2006 and 2005. 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

F-8

---

**Table of Contents**

**Sterling Financial Corporation**

**Summary of Significant Accounting Policies (Continued)**

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.

**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.

Sterling's management performed an annual test of its goodwill and other intangible assets as of June 30, 2006, and concluded that the recorded values were not impaired. There are many assumptions and estimates underlying the determination of impairment. Another estimate using different but still reasonable assumptions could produce a



**Table of Contents**

**Sterling Financial Corporation**

**Summary of Significant Accounting Policies (Continued)**

significantly different result. Additionally, future events could cause management to conclude that Sterling's goodwill or other intangible assets are 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 are recorded at fair value if, when they are acquired, they show evidence of deteriorating in terms of credit quality, and a loss is deemed likely to occur. Fair value is defined as the present value of future cash flows, including interest income, to be recognized over the life of the loan. SOP 03-3 prohibits the carryover of an allowance for loan loss on certain acquired loans within its scope that are considered in the future cash flow assessment. Sterling considers this guidance when entering into applicable transactions.

**Mortgage Banking Operations**

Sterling, mainly through Golf Savings Bank 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, 2006 and 2005, mortgage servicing rights were approximately \$7.3 million and \$5.4 million, respectively, which are net of accumulated amortization of approximately \$6.4 million and \$5.2 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.

F-10

---

**Table of Contents****Sterling Financial Corporation****Summary of Significant Accounting Policies (Continued)****Stock-Based Compensation**

On January 1, 2006, the Financial Accounting Standards Board's (FASB) Statement of Financial Accounting Standard (SFAS) No. 123(R), Share Based Payment (SFAS No. 123(R)), became effective for Sterling. As such, stock options issued as compensation are recorded as an expense at their estimated fair value. Prior to SFAS No. 123(R)'s effective date, Sterling had elected to retain the compensation measurement principles of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB No. 25). Under APB No. 25, compensation cost was recognized at the measurement date of the amount, if any, that the quoted market price of Sterling's common stock exceeded the option exercise price. Sterling has only granted its common stock options to employees with exercise prices equal to the market price of Sterling's common stock on the measurement dates. Thus, prior to the implementation of SFAS No. 123(R), no compensation cost had been recognized.

**Comprehensive Income**

In accordance with SFAS No. 130, Reporting Comprehensive Income (SFAS No. 130), Sterling reports and displays 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, 2006	\$ 0
Year ended December 31, 2005	(64)
Year ended December 31, 2004	464

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

**Hedging Activities**

As part of its mortgage banking activities, Sterling issues interest rate lock commitments (rate locks) to prospective borrowers on residential one-to-four family mortgage loan applications. Pricing for the sale of these loans is fixed with various qualified investors, such as FNMA, under both non-binding (best-efforts) and binding (mandatory) delivery programs at or near the time the interest rate is locked with the borrowers. For mandatory delivery programs, Sterling hedges IRR by entering into offsetting forward sale agreements on MBS with third parties. Risks inherent in mandatory delivery programs include the risk that if Sterling does not close the loans subject to rate locks, it is nevertheless obligated to deliver MBS to the counterparty under the forward sale agreement. Sterling could incur significant costs in acquiring replacement loans or MBS and such costs could have a material adverse effect on mortgage banking operations in future periods. At December 31, 2006, Sterling did not have any loans locked with investors under mandatory delivery programs, nor hold any offsetting forward sale agreements on MBS. As of

December 31, 2006, Sterling had entered into best efforts forward commitments to sell \$142.6 million of mortgage loans.

Rate lock commitments to borrowers and best-effort loan delivery commitments from investors are off-balance-sheet commitments that are considered to be derivatives. Sterling accounts for these commitments by recording their estimated fair value on its balance sheet. At December 31, 2006, Sterling recorded an asset of approximately \$482,000 for the estimated fair value of rate locks issued and a liability of approximately \$482,000 for the estimated fair value of delivery commitments received. As of December 31, 2005, Sterling had loans subject to rate locks under a mandatory delivery program and held off-setting forward sale agreements for MBS. Correspondingly, as of December 31, 2005, Sterling recorded an asset of \$147,000 for the fair value of rate locks

F-11

---

**Table of Contents**

**Sterling Financial Corporation**

**Summary of Significant Accounting Policies (Continued)**

and a liability of \$25,000 for the fair value of forward sale agreements.

Sterling enters into interest rate swap derivative contracts with customers. The IRR on these contracts is offset by entering into comparable dealer swaps. These contracts are carried at fair value.

**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.

**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 September 2006, the Emerging Issues Task Force (EITF) reached a consensus on Issue No. 06-4, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements. Under the provisions of EITF Issue No. 06-4, Sterling will recognize the amount, if any, that is owed current or former employees under split dollar BOLI. Also in September, the EITF Issued No. 06-5, Accounting for Purchases of Life Insurance - Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4, Accounting for Purchases of Life Insurance. EITF Issue No. 06-5 requires recognition of various other amounts under insurance contracts. EITF 06-4 is effective January 1, 2008 and EITF 06-5 is effective January 1, 2007. Sterling is currently assessing the potential impact of these standards.

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

In July 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN No. 48). This pronouncement requires a certain methodology for measuring and reporting uncertain tax positions, as well as disclosures. Adoption may result in a cumulative adjustment to income tax liabilities and retained earnings, if applicable. FIN No. 48 will be effective for Sterling as of January 1, 2007, and is not expected to have a material effect on Sterling.

In March 2006, the FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets, an amendment of SFAS No. 140 (SFAS No. 156). This pronouncement requires the recognition of a servicing asset or liability under specified circumstances, and if practicable, all separately recognized servicing assets and liabilities to be initially measured at fair value. Additionally, the pronouncement allows an entity to choose one of two methods when subsequently measuring its servicing assets and liabilities: the amortization method or the fair value method. The

amortization method provided under SFAS No. 140, employs lower of cost or market ( locom ) valuation. The new fair value method allows mark ups, in addition to the mark downs under locom. SFAS No. 156 permits a one-time reclassification of available-for-sale securities to the trading classification. Sterling currently plans to continue to employ the amortization method. Therefore, SFAS No. 156 is not expected to have a material effect on Sterling.

In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments, an amendment of SFAS No. 133 and SFAS No. 140. This statement addresses the accounting for certain hybrid financial instruments (a financial instrument with an embedded derivative) and also clarifies which interest-only

**Table of Contents**

**Sterling Financial Corporation**

**Summary of Significant Accounting Policies (Continued)**

strips and principal-only strips are not subject to the requirements of SFAS No. 133. SFAS No. 155 allows combined valuation and accounting. This statement will be effective for Sterling as of January 1, 2007. Sterling is considering implementing the combined valuation approach when applicable, and does not expect the standard to have a material impact on the consolidated financial results.

F-13

---

Table of Contents**Sterling Financial Corporation****Notes to Consolidated Financial Statements  
For the Years Ended December 31, 2006, 2005 and 2004****1. Investments and MBS:**

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

		<b>Available for sale</b>		
	<b>Amortized</b>	<b>Gross</b>	<b>Gross</b>	<b>Carrying/Fair</b>
	<b>Cost</b>	<b>Unrealized</b>	<b>Unrealized</b>	
		<b>Gains</b>	<b>Losses</b>	<b>Value</b>
December 31, 2006				
U.S. Government and agency obligations	\$ 22,462	\$ 1	\$ (135)	\$ 22,328
FHLB Seattle stock (restricted)	91,897	0	0	91,897
MBS	1,740,328	1	(52,657)	1,687,672
Other	18,681	5	0	18,686
Total	\$ 1,873,368	\$ 7	\$ (52,792)	\$ 1,820,583
December 31, 2005				
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

		<b>Held to Maturity</b>		
	<b>Amortized</b>	<b>Gross</b>	<b>Gross</b>	
	<b>Cost/ Carrying</b>	<b>Unrealized</b>	<b>Unrealized</b>	
	<b>Value</b>	<b>Gains</b>	<b>Losses</b>	<b>Fair Value</b>
December 31, 2006				
Municipal bonds	\$ 92,808	\$ 314	\$ (848)	\$ 92,274
Other	255	0	0	255
Total	\$ 93,063	\$ 314	\$ (848)	\$ 92,529
December 31, 2005				
Municipal bonds	\$ 50,907	\$ 224	\$ (400)	\$ 50,731



Other	1,017	0	0	1,017
Total	\$ 51,924	\$ 224	\$ (400)	\$ 51,748

At December 31, 2006 and 2005, accrued interest on investments and MBS was \$8.6 million and \$9.1 million, respectively.

During the years ended December 31, 2006, 2005 and 2004, Sterling sold available-for-sale investments and MBS which resulted in the following (in thousands):

	<b>Proceeds from Sales</b>	<b>Gross Realized Gains</b>	<b>Gross Realized Losses</b>
Year ended December 31, 2006	\$ 0	\$ 0	\$ 0
Year ended December 31, 2005	130,681	442	499
Year ended December 31, 2004	635,269	6,390	1,819

F-14

---

**Table of Contents****Sterling Financial Corporation****Notes to Consolidated Financial Statements (Continued)**

At December 31, 2006, 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 Cost</b>	<b>Fair Value</b>
Available-for-sale MBS:		
1 to 5 years	\$ 80,747	\$ 78,196
After 5 years through 10 years	9,382	9,115
After 10 years	1,650,199	1,600,361
	\$ 1,740,328	\$ 1,687,672
Available-for-sale U.S. Government and agency obligations:		
Under 1 year	\$ 12,472	\$ 12,469
After 1 year through 5 years	9,990	9,859
	\$ 22,462	\$ 22,328
FHLB Seattle stock (restricted) and other available for sale:		
After 5 years through 10 years	\$ 0	\$ 0
After 10 years	110,578	110,583
	\$ 110,578	\$ 110,583
Held-to-maturity municipal bonds:		
Under 1 year	\$ 1,800	\$ 1,802
After 1 year through 5 years	1,755	1,722
After 5 through 10 years	9,445	9,381
After 10 years	79,808	79,369
	\$ 92,808	\$ 92,274
Other held-to-maturities securities:		
Under 1 year	\$ 80	\$ 80
After 1 year through 5 years	175	175
	\$ 255	\$ 255

**Table of Contents****Sterling Financial Corporation****Notes to Consolidated Financial Statements (Continued)**

In accordance with FASB Staff Position 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):

	<b>Less than 12 Months Unrealized</b>		<b>12 Months or Longer Unrealized</b>		<b>Total Unrealized</b>	
	<b>Market Value</b>	<b>Losses</b>	<b>Market Value</b>	<b>Losses</b>	<b>Market Value</b>	<b>Losses</b>
December 31, 2006						
U.S. Government and agency obligations	\$ 2,003	\$ (2)	\$ 11,855	\$ (134)	\$ 13,858	\$ (136)
Municipal bonds	42,236	(564)	24,861	(283)	67,097	(847)
MBS	47,503	(238)	1,630,945	(52,420)	1,678,448	(52,658)
Total	\$ 91,742	\$ (804)	\$ 1,667,661	\$ (52,837)	\$ 1,759,403	\$ (53,641)
December 31, 2005						
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	958,156	(16,040)	934,828	(38,078)	1,892,984	(54,118)
Total	\$ 983,941	\$ (16,308)	\$ 961,318	\$ (38,394)	\$ 1,945,259	\$ (54,702)

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, 2006 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 impaired in value, and Sterling has the positive intent and ability to hold these investments until recovery.

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, 2006 and 2005, U.S. government and agency obligations and MBS with an aggregate fair value of \$128.7 million and \$68.7 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 (Continued)****2. Loans Receivable:**

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

	<b>December 31,</b>	
	<b>2006</b>	<b>2005</b>
Residential real estate	\$ 654,661	\$ 488,633
Multifamily real estate	263,053	332,211
Commercial real estate	795,386	792,219
Construction	2,290,882	1,021,502
Consumer direct	749,626	618,528
Consumer indirect	288,704	166,143
Commercial banking	2,069,086	1,531,079
Total loans receivable	7,111,398	4,950,315
Deferred loan fees, net	(12,308)	(8,916)
Gross loans receivable	7,099,090	4,941,399
Allowance for losses on loans	(83,689)	(55,483)
Net loans receivable	\$ 7,015,401	\$ 4,885,916

Net accrued interest on loans receivable was approximately \$46.8 million and \$26.7 million at December 31, 2006 and 2005, respectively.

The following table sets forth the scheduled contractual principal repayments for Sterling's loan portfolio at December 31, 2006. 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 Outstanding at December 31, 2006</b>	<b>Principal Payments</b>		
		<b>Contractually Due in Fiscal Years</b>		
		<b>2007</b>	<b>2008-2011</b>	<b>Thereafter</b>
		<b>(In thousands)</b>		
Mortgage permanent:				
Fixed rate	\$ 785,819	\$ 50,989	\$ 191,245	\$ 543,585
Variable rate	927,281	67,120	263,518	596,643

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

Mortgage construction	2,290,882	1,562,065	682,318	46,499
Consumer direct	749,626	271,566	139,410	338,650
Consumer indirect	288,704	60,201	201,032	27,471
Commercial banking	2,069,086	1,071,813	509,287	487,986
	\$ 7,111,398	\$ 3,083,754	\$ 1,986,810	\$ 2,040,834

Sterling originates the majority of its loans throughout the western United States. The value of real estate properties in the western United States 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

F-17

---

**Table of Contents****Sterling Financial Corporation****Notes to Consolidated Financial Statements (Continued)**

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.

**3. 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>Years Ended December 31,</b>		
	<b>2006</b>	<b>2005</b>	<b>2004</b>
Allowance for losses on loans			
Balance, January 1	\$ 55,483	\$ 49,362	\$ 35,605
Provision	18,703	15,200	12,150
Allowance for losses on assets acquired	13,155	0	6,722
Amounts written off	(4,405)	(9,651)	(5,483)
Recoveries	753	572	368
Balance, December 31	83,689	55,483	49,362
Allowance for losses on real estate owned			
Balance, January 1	17	0	3
Provision	170	23	5
Amounts written off	(187)	(6)	(8)
Recoveries	0	0	0
Balance, December 31	0	17	0
Total allowance for losses on loans and real estate owned	\$ 83,689	\$ 55,500	\$ 49,362

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>2006</b>	<b>2005</b>
Non-accrual loans(1)	\$ 7,107	\$ 6,542
Restructured loans(2)	0	1,081
Total impaired loans	\$ 7,107	\$ 7,623

- (1) The total allowance for losses on loans related to these loans was \$1.4 million and \$2.2 million at December 31, 2006 and 2005, respectively. Interest income of \$249,000, \$258,000 and \$659,000, was recorded during the years ended December 31, 2006, 2005 and 2004, respectively, in connection with such loans. For loans on non-accrual status at year end, additional gross interest income of \$321,000, \$693,000 and \$1,348,000, would have been recorded during the years ended December 31, 2006, 2005 and 2004, 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, 2006, 2005 and 2004 was \$5.4 million, \$12.3 million and \$13.9 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

F-18

---



**Table of Contents****Sterling Financial Corporation****Notes to Consolidated Financial Statements (Continued)**

with their new terms are not included in non-accrual loans unless there is uncertainty as to the ultimate collection of principal or interest.

**4. 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>December 31,</b>	
	<b>2006</b>	<b>2005</b>
Residential	\$ 621,597	\$ 606,807
Commercial	1,638,748	814,316
Consumer	724	3,098
Total	\$ 2,261,069	\$ 1,424,221

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

	<b>Years Ended December 31,</b>	
	<b>2006</b>	<b>2005</b>
Balance, January 1	\$ 5,430	\$ 4,078
Originated servicing	797	2,790
Amortization	(1,160)	(1,754)
Acquired	2,268	316
Balance, December 31	\$ 7,335	\$ 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, 2006, 2005 and 2004, Sterling sold approximately \$54.9 million, \$125.5 million and \$16.3 million in commercial real estate loans under participation agreements, resulting in net gains of \$747,000, \$449,000 and \$44,000, respectively.

**5. Office Properties and Equipment:**

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

	<b>December 31,</b>		<b>Estimated</b>
	<b>2006</b>	<b>2005</b>	<b>Useful Life</b>
Buildings and improvements	\$ 55,583	\$ 57,678	20-40 years
Furniture, fixtures, equipment and computer software	66,733	55,002	3-10 years
Leasehold improvements	12,896	7,716	5-20 years
Automobiles	116	178	3-5 years
	135,328	120,574	
Less accumulated depreciation and amortization	(55,346)	(51,236)	
	79,982	69,338	
Land	13,814	13,094	
Total office properties and equipment	\$ 93,796	\$ 82,432	

F-19

---

**Table of Contents****Sterling Financial Corporation****Notes to Consolidated Financial Statements (Continued)**

During the year ended December 31, 2006, Sterling entered into sale leaseback transactions on full service branches and administrative offices with a total net book value of \$10.6 million, resulting in a gain of \$10.3 million to be recognized over the life of the leases.

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

The changes in the carrying value of goodwill for the years ended December 31, 2006 and 2005 are as follows (in thousands):

	<b>Amount</b>
Balance as of January 1, 2005	\$ 112,398
Goodwill added	309
Balance at December 31, 2005	112,707
Goodwill acquired during the year	134,129
Goodwill added	408
Balance as of December 31, 2006	\$ 247,244

As of December 31, 2005, the majority of goodwill was allocated to the community banking segment. In 2006, goodwill of \$30.9 million acquired in the Lynnwood Financial Group, Inc. ( Lynnwood ) acquisition was allocated to the residential mortgage banking segment. Also in 2006, goodwill acquired in the FirstBank NW Corp. ( FirstBank ) acquisition in the amount of \$102.3 million was allocated to the community banking segment. During 2006 and 2005, goodwill added in the amount of \$408,000 and \$309,000, respectively, reflected contingent consideration earned on the acquisition of Peter W. Wong Associates, Inc. ( PWWA ).

The carrying value of core deposit intangibles at December 31, 2006 and 2005 are as follows (in thousands):

	<b>December 31,</b>	
	<b>2006</b>	<b>2005</b>
Gross carrying value	\$ 35,682	\$ 22,332
Accumulated amortization	(7,112)	(4,707)
Net carrying value	\$ 28,570	\$ 17,625

The values of the core deposit intangibles are amortized over the estimated useful life of the deposit relationship, which is generally 5 to 10 years. Core deposit intangible amortization expense for 2006 was \$2.4 million and each of 2005 and 2004 was \$2.2 million.

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>
2007	\$ 3,786
2008	3,786
2009	3,786
2010	3,786
2011	3,676

F-20

---

**Table of Contents****Sterling Financial Corporation****Notes to Consolidated Financial Statements (Continued)****7. Deposits:**

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

	<b>December 31, 2006</b>		<b>December 31, 2005</b>	
	<b>Amount</b>	<b>%</b>	<b>Amount</b>	<b>%</b>
	<b>(Dollars in thousands)</b>			
Interest-bearing transaction	\$ 483,551	7.2	\$ 432,936	9.0
Noninterest-bearing transaction	834,140	12.4	673,934	14.0
Savings and MMDA	1,830,313	27.1	1,312,033	27.3
Time deposits	3,598,024	53.3	2,387,398	49.7
Total deposits	\$ 6,746,028	100.0	\$ 4,806,301	100.0
Annualized cost of deposits		3.32%		2.16%

Deposit growth was primarily in savings and time deposits, reflecting consumer demand, the use of brokered CDs as a cost competitive source of funds, and the deposit mix of acquired entities.

At December 31, 2006, the scheduled maturities of time deposit accounts are as follows (in thousands):

	<b>Amount</b>	<b>Weighted Average Interest Rate</b>
Due within 1 year	\$ 3,119,514	4.89%
Due in 1 to 2 years	174,248	4.21
Due in 2 to 3 years	105,417	4.27
Due in 3 to 4 years	78,344	4.88
Due in 4 to 5 years	42,838	5.14
Due after 5 years	77,663	4.76
	\$ 3,598,024	

At December 31, 2006 and 2005, the remaining maturities of time deposit accounts with a minimum balance of \$100,000 were as follows (in thousands):

**December 31,**

	<b>2006</b>	<b>2005</b>
Three months or less	\$ 931,437	\$ 525,623
After three months through six months	644,825	332,184
After six months through twelve months	509,732	449,559
After twelve months	212,639	201,183
	\$ 2,298,633	\$ 1,508,549

F-21

---

**Table of Contents****Sterling Financial Corporation****Notes to Consolidated Financial Statements (Continued)****7. Deposits, Continued:**

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

	<b>Years Ended December 31,</b>		
	<b>2006</b>	<b>2005</b>	<b>2004</b>
Transaction accounts	\$ 1,692	\$ 1,340	\$ 837
Savings and MMDA	47,844	22,272	11,347
Time deposits	135,737	68,378	41,299
	\$ 185,273	\$ 91,990	\$ 53,483

**8. 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 \$2.46 billion and \$1.95 billion at December 31, 2006 and 2005, 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, 2006, Sterling Savings Bank had the ability to borrow an additional \$734.9 million from FHLB Seattle.

The advances from FHLB Seattle at December 31, 2006 and 2005, are repayable as follows (in thousands):

	<b>December 31, 2006</b>		<b>December 31, 2005</b>	
	<b>Amount</b>	<b>Weighted Average Interest Rate</b>	<b>Amount</b>	<b>Weighted Average Interest Rate</b>
Due within 1 year	\$ 803,307	5.14%	\$ 670,047	3.39%
Due in 1 to 2 years	148,019	4.71	131,018	3.76
Due in 2 to 3 years	83,596	5.28	120,636	4.30
Due in 3 to 4 years	195,941	4.86	168,000	3.81
Due in 4 to 5 years	11,579	5.00	225,000	4.41
Due after 5 years	66,175	4.60	128,761	4.23
	\$ 1,308,617	5.03%	\$ 1,443,462	3.84%

**9. 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. 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, 2006, under the reverse repurchase agreements, Sterling has pledged as collateral investments and MBS with aggregate amortized costs and market values of \$677.9 million and \$652.5 million, respectively.

The average balances of reverse repurchase agreements were \$632.0 million and \$634.8 million during the years ended December 31, 2006 and 2005, respectively. The maximum amount outstanding at any month end during these same periods was \$675.5 million and \$821.4 million, respectively.

F-22

---



**Table of Contents****Sterling Financial Corporation****Notes to Consolidated Financial Statements (Continued)**

At December 31, 2006 and 2005, securities sold subject to repurchase agreements are repayable as follows (in thousands):

	<b>December 31, 2006</b>		<b>December 31, 2005</b>	
	<b>Amount</b>	<b>Weighted Average Interest Rate</b>	<b>Amount</b>	<b>Weighted Average Interest Rate</b>
Due within 1 yr	\$ 86,354	4.81%	\$ 261,676	4.07%
Due within 2 yrs	40,000	4.82	0	0.00
Due within 3 yrs	40,000	4.77	0	0.00
Due within 4 yrs	50,000	4.34	0	0.00
Due after 4 yrs	400,000	4.18	350,000	3.39
	\$ 616,354	4.35%	\$ 611,676	3.68%

**10. Other Borrowings:**

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

	<b>December 31,</b>	
	<b>2006</b>	<b>2005</b>
Junior Subordinated Debentures	\$ 236,772	\$ 108,707
Other	3,454	1,981
Total other borrowings	\$ 240,226	\$ 110,688

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



**Table of Contents****Sterling Financial Corporation****Notes to Consolidated Financial Statements (Continued)**

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>Rate at December 31, 2006</b>	<b>Amount (in Thousands)</b>
Sterling Capital Trust VIII	Sept 2006	Sept 2036	Sept 2011	Floating	6.99%	\$ 51,547
Sterling Capital Trust VII	June 2006	June 2036	June 2011	Floating	6.89	56,702
Lynnwood Capital Trust II	June 2005	June 2035	June 2010	Floating	7.16	10,310
Sterling Capital Trust VI	June 2003	Sept 2033	Sept 2008	Floating	8.56	10,310
Sterling Capital Statutory Trust V	May 2003	May 2033	June 2008	Floating	8.62	20,619
Sterling Capital Trust IV	May 2003	May 2033	May 2008	Floating	8.52	10,310
Sterling Capital Trust III	April 2003	April 2033	April 2008	Floating	8.62	14,433
Lynnwood Capital Trust I	Mar 2003	Mar 2033	Mar 2007	Floating	8.52	9,484
Klamath First Capital Trust II	April 2002	April 2032	April 2007	Floating	9.09	13,154
Klamath First Capital Trust I	July 2001	July 2031	June 2006	Floating	9.30	15,160
Sterling Capital Trust II	July 2001	July 2031	June 2006	Fixed	10.25	24,743
					8.02%*	\$ 236,772

\* Weighted average rate

On August 21, 2006, Sterling entered into a \$30 million one-year variable-rate revolving credit agreement (the Credit Facility ) with Wells Fargo Bank, National Association, replacing a \$40 million credit facility Sterling previously had with Bank of Scotland. As of December 31, 2006, no amount was drawn on the credit facility. Amounts loaned pursuant to the Credit Facility will bear interest, at Sterling's election, at either two percent below prime, or at LIBOR plus 90 basis points. The Credit Facility contains representations and warranties, and negative and affirmative covenants by Sterling, including financial covenants and restrictions on certain actions by Sterling, such as Sterling's ability to incur debt, make investments and merge into or consolidate with other entities. The Credit Facility may be terminated and loans under the Credit Facility may be accelerated if an event of default occurs, as defined in the Credit Facility. Sterling is obligated to repay the principal balance of any advances issued pursuant to the Credit Facility on August 3, 2007.

**Table of Contents****Sterling Financial Corporation****Notes to Consolidated Financial Statements (Continued)****11. 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>2006</b>	<b>2005</b>	<b>2004</b>
Current income taxes:			
Federal	\$ 38,436	\$ 21,667	\$ 17,229
State	3,361	1,525	1,801
Total current income taxes	41,797	23,192	19,030
Deferred income taxes:			
Federal	(6,959)	5,703	8,031
State	(608)	509	729
Total deferred income taxes	(7,567)	6,212	8,760
Total income tax expense	\$ 34,230	\$ 29,404	\$ 27,790

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>2006</b>		<b>2005</b>	
	<b>Assets</b>	<b>Liabilities</b>	<b>Assets</b>	<b>Liabilities</b>
Allowance for losses on loans	\$ 31,123	\$ 0	\$ 20,057	\$ 0
Unrealized losses on available-for-sale securities	19,532	0	20,025	0
Purchase accounting premiums/discounts	15,581	19,636	12,314	12,941
Deferred compensation	6,333	0	4,775	0
FHLB Seattle dividends	0	16,016	0	12,930
Deferred loan fees	0	4,258	0	3,280
Office properties and equipment	2,408	0	0	2,417
Mortgage servicing rights	0	2,634	0	1,801
Nonaccrual loans	168	0	527	0
Prepaid expenses	0	444	0	570
Other	0	1,322	0	0
	\$ 75,145	\$ 44,310	\$ 57,698	\$ 33,939

F-25

---

**Table of Contents****Sterling Financial Corporation****Notes to Consolidated Financial Statements (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,					
	2006		2005		2004	
	Amount	%	Amount	%	Amount	%
Income tax provision at the federal statutory rate	\$ 37,862	35.0%	\$ 31,718	35.0%	\$ 29,433	35.0%
Tax effect of:						
State taxes, net of federal benefit	1,333	1.2	1,322	1.5	1,644	2.0
Tax-exempt interest	(998)	(0.9)	(655)	(0.7)	(770)	(0.9)
Bank owned life insurance	(1,735)	(1.6)	(2,070)	(2.3)	(1,519)	(1.8)
Acquisition costs	0	0.0	0	0.0	(366)	(0.4)
Tax credits	(1,433)	(1.4)	(874)	(1.0)	(531)	(0.6)
Other, net	(799)	(0.7)	(37)	(0.1)	(101)	(0.1)
	\$ 34,230	31.6%	\$ 29,404	32.4%	\$ 27,790	33.2%

**12. Stock Options:**

Stock option transactions are summarized as follows:

	2006		2005		2004	
	Number	Weighted Average Exercise Price	Number	Weighted Average Exercise Price	Number	Weighted Average Exercise Price
Balance, January 1	1,703,959	\$ 19.46	1,793,975	\$ 15.18	1,560,464	\$ 9.61
Granted	20,000	25.28	401,000	25.71	478,500	26.49
Exercised	(495,208)	13.60	(491,016)	8.93	(895,287)	8.09
Acquisitions	265,160	9.35	0	0.00	650,298	10.38
Cancelled	(8,250)	8.91	0	0.00	0	0.00
Balance, December 31	1,485,661	\$ 19.72	1,703,959	\$ 19.46	1,793,975	\$ 15.18
Exercisable	1,485,661		1,700,659		1,166,280	

At December 31, 2006, the weighted average remaining contractual life and the aggregate intrinsic value of stock options outstanding and exercisable was 5.1 years and \$20.9 million, respectively.

As of December 31, 2006, a total of 436,249 stock options remained available for grant under Sterling's 2001 and 2003 Long-Term Incentive Plans. These options have terms of four, six or ten years. During the years ended December 31, 2006, 2005 and 2004, the fair value of options granted were \$8.55, \$7.91 and \$11.77, respectively, and the intrinsic value of options exercised were \$8.8 million, \$8.0 million and \$14.0 million, respectively. Stock compensation expense recognized during the year ended December 31, 2006 was \$182,000. Had SFAS No. 123(R)

F-26

---

**Table of Contents****Sterling Financial Corporation****Notes to Consolidated Financial Statements (Continued)**

been effective during the years ended December 31, 2005 and 2004, Sterling's reported net income and earnings per share would have been the following pro forma amounts:

	<b>Years Ended December 31,</b>	
	<b>2005</b>	<b>2004</b>
Reported net income:	\$ 61,219	\$ 56,305
Add back: Stock-based employee compensation expense, net of related tax effects	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)
Pro forma net income	\$ 57,900	\$ 48,974
Basic earnings per share:		
Reported earnings per share	\$ 1.77	\$ 1.66
Stock-based employee compensation, fair value	(0.10)	(0.22)
Pro forma earnings per share	\$ 1.67	\$ 1.44
Diluted earnings per share:		
Reported earnings per share	\$ 1.75	\$ 1.62
Stock-based employee compensation, fair value	(0.09)	(0.21)
Pro forma earnings per share	\$ 1.66	\$ 1.41

The Black-Scholes option-pricing model was used in estimating the fair value of option grants. The weighted average assumptions used are presented in the following table:

	<b>Years Ended December 31,</b>		
	<b>2006</b>	<b>2005</b>	<b>2004</b>
Expected volatility	31%	32 %	37 % - 132%
Expected lives (in years)	5.5	2.9 - 5.4	4 - 10
Risk free interest rates	4.36%	4.37 % - 4.44%	1.77 % - 6.52%
Expected forfeiture rate	0%	0 %	0 %
Annual dividend yield	0.87%	0.87 % - 1.04%	0 %

The following table summarizes information about Sterling's plans at December 31, 2006:



Range of Exercise Prices	Number Outstanding	Options Outstanding		Options Exercisable	
		Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
\$ 4.27 - \$ 8.01	167,010	2.8 years	\$ 5.64	167,010	\$ 5.64
\$ 8.01 - \$12.02	247,884	3.6 years	9.71	247,884	9.71
\$ 12.02 - \$16.03	24,631	6.9 years	14.01	24,631	14.01
\$ 16.03 - \$20.04	251,767	5.1 years	19.38	251,767	19.38
\$ 20.04 - \$24.01	23,869	6.9 years	21.84	23,869	21.84
\$ 24.01 - \$26.71	770,500	6.0 years	26.21	770,500	26.21
	1,485,661			1,485,661	

F-27

**Table of Contents****Sterling Financial Corporation****Notes to Consolidated Financial Statements (Continued)**

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 stock splits to date.

**13. Shareholders Equity:**

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, Sterling issued a 10% stock dividend. 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.

On July 5, 2006, Sterling issued 1,799,961 shares of common stock in its acquisition of Lynnwood. On November 30, 2006, Sterling issued 4,821,913 shares of common stock in its acquisition of FirstBank. Also during the year, Sterling issued 12,004 shares of common stock on both January 17, 2006 and December 29, 2006 in connection with the earn out provisions of INTERVEST's 2004 acquisition of PWWA.

In July 2006, Sterling filed with the SEC a shelf registration statement on Form S-3 for the issuance of up to \$100 million in common stock and preferred stock. As of December 31, 2006, no shares had been issued under the registration statement.

Sterling has paid the following historical cash dividends:

<b>Date Paid</b>	<b>Per Share Amount</b>	<b>Total</b>
October 2005	\$ 0.050	\$ 1.7 million
January 2006	0.055	1.9 million
April 2006	0.060	2.1 million
July 2006	0.065	2.3 million
October 2006	0.070	2.6 million
January 2007	0.075	3.2 million

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.

**14. 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

F-28

---

Table of Contents**Sterling Financial Corporation****Notes to Consolidated Financial Statements (Continued)**

the period. All prior period per share amounts have been restated to reflect the three for two stock split in August 2005.

<b>For the Year Ended December 31, 2006</b>			
<b>Weighted Average</b>			
	<b>Net Income (Numerator)</b>	<b>Shares (Denominator)</b>	<b>Per Share Amount</b>
Earnings per common share basic	\$ 73,946	36,423,095	\$ 2.03
Effect of dilutive securities:			
Common stock options	0	418,771	(0.02)
Contingently issuable shares	0	0	0.00
Earnings per common share diluted	\$ 73,946	36,841,866	\$ 2.01
Antidilutive options not included in diluted earnings per share		237,850	

<b>For the Year Ended December 31, 2005</b>			
<b>Weighted Average</b>			
	<b>Net Income (Numerator)</b>	<b>Shares (Denominator)</b>	<b>Per Share Amount</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>Weighted Average</b>		
	<b>Net Income (Numerator)</b>	<b>Shares (Denominator)</b>
		<b>Per Share Amount</b>

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

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		

**15. Regulatory Capital:**

Sterling, Sterling Savings Bank and Golf Savings Bank are required by applicable regulations to maintain certain minimum capital levels. Sterling's management intends to enhance the capital resources and regulatory capital ratios of Sterling and its banking subsidiaries through the retention of an adequate amount of earnings and the management of the level and mix of assets, although there can be no assurance in this regard. Sterling Savings Bank and Golf Savings Bank have each received notification from their respective primary regulator that, as of

F-29

---

**Table of Contents****Sterling Financial Corporation****Notes to Consolidated Financial Statements (Continued)**

December 31, 2006 and 2005, each of the companies has been categorized as well capitalized pursuant to applicable regulations. There have been no conditions or events since notification that management believes have changed these classifications. The following table sets forth their respective capital positions at December 31, 2006.

	<b>Minimum Capital Requirements</b>		<b>Well-Capitalized Requirements</b>		<b>Actual</b>	
	<b>Amount</b>	<b>Ratio</b>	<b>Amount</b>	<b>Ratio</b>	<b>Amount</b>	<b>Ratio</b>
As of December 31, 2006:						
Tier 1 leverage (to average assets)						
Sterling	\$ 361,112	4.0%	\$ 451,390	5.0%	\$ 787,630	8.7%
Sterling Savings Bank	349,254	4.0	436,568	5.0	749,567	8.6
Golf Savings Bank	11,484	4.0	14,355	5.0	19,728	6.9
Tier I (to risk-weighted assets)						
Sterling	315,401	4.0	473,101	6.0	787,630	10.0
Sterling Savings Bank	308,994	4.0	463,491	6.0	749,567	9.7
Golf Savings Bank	7,280	4.0	10,920	6.0	19,728	10.8
Total (to risk-weighted assets)						
Sterling	630,802	8.0	788,502	10.0	871,319	11.1
Sterling Savings Bank	617,988	8.0	772,486	10.0	832,074	10.8
Golf Savings Bank	14,560	8.0	18,200	10.0	20,910	11.5
As of December 31, 2005:						
Tier 1 leverage (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
Golf Savings Bank(1)	N/A	N/A	N/A	N/A	N/A	N/A
Tier I (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
Golf Savings Bank(1)	N/A	N/A	N/A	N/A	N/A	N/A
Total (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
Golf Savings Bank(1)	N/A	N/A	N/A	N/A	N/A	N/A

(1) Golf Savings Bank's capital ratios have not been disclosed for periods prior to Sterling's acquisition of Golf Savings Bank in July 2006.

**16. 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.

F-30

---

**Table of Contents****Sterling Financial Corporation****Notes to Consolidated Financial Statements (Continued)**

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

	<b>December 31,</b>	
	<b>2006</b>	<b>2005</b>
Undisbursed loan funds – construction loans	\$ 1,421,104	\$ 911,864
Undisbursed lines of credit – commercial loans	746,084	579,182
Undisbursed lines of credit – consumer loans	288,839	247,030
Firm commitments to purchase loans	33,378	13,911
Firm commitments to sell loans	104,061	22,408

As of December 31, 2006 and 2005, Sterling had approximately \$46.5 million and \$37.5 million of commercial and standby letters of credit outstanding, respectively. During the years ended December 31, 2006 and 2005, Sterling collected approximately \$377,000 and \$240,000 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, 2006 and 2005.

As of December 31, 2006, 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, 2006, \$2.8 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, 2006, 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>
2007	\$ 11,703
2008	10,898
2009	9,351
2010	8,426
2011	6,556
Thereafter	39,418
	<b>\$ 86,352</b>



Rent expense recorded for the years ended December 31, 2006, 2005 and 2004 was \$9.3 million, \$5.9 million and \$4.5 million, respectively.

**17. 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

F-31

---

**Table of Contents**

**Sterling Financial Corporation**

**Notes to Consolidated Financial Statements (Continued)**

Sterling common stock. During the years ended December 31, 2006, 2005 and 2004, Sterling contributed approximately \$1.8 million, \$1.4 million and \$1.3 million, 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, 2006, 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 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 \$209,000, \$80,000 and \$129,000 in expense related to this plan for the years ending December 31, 2006, 2005 and 2004, 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 for the years ended December 31, 2006 and 2005, and \$1.6 million for the year ended December 31, 2004 in expenses related to these plans. As of December 31, 2006 and 2005, Sterling had \$13.6 million and \$10.0 million, respectively, accrued as future obligations associated with these plans.

In 2006, Sterling adopted a nonqualified Deferred Compensation Plan. The Deferred Compensation Plan is designed to retain and attract key employees. Plan participation is limited to Directors and a select group of management or highly compensated employees as determined by the Plan Committee. As of December 31, 2006, there were 34 participants in the Deferred Compensation Plan. Under the plan, participants may contribute up to 75% of their base salary and up to 100% of commissions, bonus and director fees. The deferred amounts are credited to the participants' accounts, which do not hold assets but are maintained for record-keeping purposes. The amounts deferred under the Plan are credited based on the return of measurement funds selected by the participants. The measurement funds are designed to mirror the performance of mutual funds selected by the Plan Committee. All participant contributions vest immediately. Each year, based on a written agreement or at its sole discretion, Sterling may contribute amounts to all, some or none of the participants. The vesting of the Sterling contributions is determined based on a written agreement between the participant and Sterling or based on a vesting schedule determined by the Plan Committee. Within 60 days after the later of the first business day of the plan year following the plan year in which the participant retires, or the last day of the six month period immediately following the date on which the participant retires, the participant's

account will be distribute either in a lump sum or installments up to 15 years as elected by the participant. Within 60 days after the Plan Committee is notified of the participants death or the participant becomes disabled, the participants account will be distributed in a lump sum. Within 60 days after the last day of the six month period immediately following the date on which employment terminates, the participant s account will be distribute in a lump sum payment. Participants may elect to receive a scheduled

F-32

---

**Table of Contents****Sterling Financial Corporation****Notes to Consolidated Financial Statements (Continued)**

distribution with certain exclusions. As of December 31, 2006, Sterling had accrued \$1.4 million to reflect the anticipated liability.

**18. Non-Interest Expenses:**

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

	<b>Years Ended December 31,</b>		
	<b>2006</b>	<b>2005</b>	<b>2004</b>
Employee compensation and benefits	\$ 117,186	93,367	\$ 77,617
Occupancy and equipment	32,769	26,411	23,051
Data processing	14,180	12,678	10,596
Depreciation	10,280	8,627	7,321
Advertising	9,985	9,125	6,976
Travel and entertainment	5,955	4,522	4,071
Legal and accounting	2,478	3,134	3,075
Amortization of core deposit intangibles	2,405	2,222	2,222
Insurance	1,360	1,213	1,155
Merger and acquisition costs	454	0	4,835
Goodwill litigation	275	179	141
Other	9,046	8,803	7,310
	\$ 206,373	170,281	\$ 148,370

**19. Segment Information:**

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

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

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

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

The Retail Brokerage segment markets fixed income and equity products, mutual funds, fixed and variable annuities, insurance and other financial products within the Sterling Savings Bank financial service center

network through sales representatives of Sterling Savings Bank's subsidiary Harbor Financial Services, Inc.

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

F-33

---

**Table of Contents****Sterling Financial Corporation****Notes to Consolidated Financial Statements (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, 2006, 2005 and 2004 (in thousands):

	<b>As of and for the Year Ended December 31, 2006</b>					
	<b>Community Banking</b>	<b>Residential Mortgage Banking</b>	<b>Commercial Mortgage Banking</b>	<b>Retail Brokerage</b>	<b>Other and Eliminations</b>	<b>Total</b>
Interest income	\$ 514,156	\$ 28,899	\$ 9,298	\$ 0	\$ (1,498)	\$ 550,855
Interest expense	(269,164)	(7,153)	0	0	(10,626)	(286,943)
Net interest income (expense)	244,992	21,746	9,298	0	(12,124)	263,912
Provision for losses on loans	(18,613)	(90)	0	0	0	(18,703)
Noninterest income	55,569	18,875	6,047	3,445	(14,596)	69,340
Noninterest expense	(161,121)	(30,694)	(9,101)	(3,010)	(2,447)	(206,373)
Income (loss) before income taxes	\$ 120,827	\$ 9,837	\$ 6,244	\$ 435	\$ (29,167)	\$ 108,176
Total assets	\$ 9,596,998	\$ 326,462	\$ 10,929	\$ 947	\$ (106,684)	\$ 9,828,652

	<b>As of and for the Year Ended December 31, 2005</b>					
	<b>Community Banking</b>	<b>Residential Mortgage Banking</b>	<b>Commercial Mortgage Banking</b>	<b>Retail Brokerage</b>	<b>Other and 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 (expense)	204,513	11,794	8,099	0	(7,871)	216,535
Provision for losses on 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 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
--------------	----	-----------	----	--------	----	--------	----	-----	----	-----------	----	-----------

F-34

---

**Table of Contents****Sterling Financial Corporation****Notes to Consolidated Financial Statements (Continued)**

	<b>As of and for the Year Ended December 31, 2004</b>					
	<b>Community Banking</b>	<b>Residential Mortgage Banking</b>	<b>Commercial Mortgage Banking</b>	<b>Retail Brokerage</b>	<b>Other and 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 (expense)	188,628	8,912	7,280	1	(8,005)	196,816
Provision for losses on 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 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

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

The following tables present Sterling's condensed operations on a quarterly basis for the years ended December 31, 2006 and 2005 (in thousands, except per share amounts):

	<b>Year Ended December 31, 2006</b>			
	<b>First Quarter</b>	<b>Second Quarter</b>	<b>Third Quarter</b>	<b>Fourth Quarter</b>
Interest income	\$ 116,179	\$ 126,720	\$ 148,208	\$ 159,748
Interest expense	(57,223)	(65,671)	(78,175)	(85,874)
Provision for losses on loans	(4,650)	(4,650)	(4,698)	(4,705)
Net interest income after provision for losses on loans	54,306	56,399	65,335	69,169
Other income	12,917	15,130	18,451	22,842
Operating expenses	(44,240)	(46,989)	(55,302)	(59,842)
Income before income taxes	22,983	24,540	28,484	32,169
Income tax provision	(7,567)	(7,609)	(9,145)	(9,909)
Net income	\$ 15,416	\$ 16,931	\$ 19,339	\$ 22,260



Earnings per share	basic	\$	0.44	\$	0.48	\$	0.52	\$	0.57
Earnings per share	diluted	\$	0.44	\$	0.48	\$	0.52	\$	0.57
Weighted average shares outstanding	basic		34,946,649		35,077,647		36,891,986		38,729,376
Weighted average shares outstanding	diluted		35,255,602		35,404,364		37,273,560		39,159,001

F-35

---

**Table of Contents****Sterling Financial Corporation****Notes to Consolidated Financial Statements (Continued)**

	<b>Year Ended December 31, 2005</b>			
	<b>First Quarter</b>	<b>Second Quarter</b>	<b>Third Quarter</b>	<b>Fourth 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

**21. 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.

F-36

---

**Table of Contents****Sterling Financial Corporation****Notes to Consolidated Financial Statements (Continued)*****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.

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

	<b>December 31,</b>		<b>2005</b>	
	<b>2006</b>			
	<b>Carrying</b>	<b>Fair</b>	<b>Carrying</b>	<b>Fair Value</b>
	<b>Amount</b>	<b>Value</b>	<b>Amount</b>	
Financial assets:				
Cash and cash equivalents	\$ 179,715	\$ 179,715	\$ 132,169	\$ 132,169
Investments and MBS:				
Available for sale	1,820,583	1,820,583	2,076,615	2,076,615
Held to maturity	93,063	92,529	51,924	51,748
Loans held for sale	91,469	91,469	7,894	7,894

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

Loans receivable, net	7,015,401	6,947,660	4,885,916	4,883,265
Accrued interest receivable	55,519	55,519	35,805	35,805
Financial liabilities:				
Non-maturity deposits	3,148,004	3,148,004	2,418,903	2,418,903
Deposits with stated maturities	3,598,024	3,600,415	2,387,398	2,382,189
Borrowings	2,165,197	2,148,717	2,165,826	2,115,145
Accrued interest payable	39,863	39,863	18,169	18,169

The fair value estimates above do not include the value of mortgage servicing rights on Sterling's residential and commercial mortgage servicing portfolio of approximately \$2.26 billion and \$1.42 billion at December 31,

F-37

---

**Table of Contents****Sterling Financial Corporation****Notes to Consolidated Financial Statements (Continued)**

2006 and 2005, respectively. At December 31, 2006 and 2005, mortgage servicing rights were approximately \$7.3 million and \$5.4 million, respectively, which are net of accumulated amortization of approximately \$6.4 million and \$5.2 million, respectively.

**22. Related-Party Transactions:**

One of Sterling Savings Bank's directors is a principal in a law firm that provides legal services to Sterling. During the years ended December 31, 2006, 2005 and 2004, Sterling incurred legal fees of approximately \$3.2 million, \$1.9 million and \$2.2 million, respectively, related to services provided by this firm.

At December 31, 2006 and 2005, loans outstanding to directors and executive officers were \$42.4 million and \$16.3 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.

During the year, the balance of loans outstanding to directors and executive officers changed as follows:

	<b>2006</b>
Balance, January 1	\$ 16,265
New	37,693
Repayments	(11,512)
Balance, December 31	\$ 42,446

**Table of Contents****Sterling Financial Corporation****Notes to Consolidated Financial Statements (Continued)****23. 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>2006</b>	<b>2005</b>
Assets:		
Cash and cash equivalents	\$ 21,056	\$ 15,706
Investments in subsidiaries:		
Sterling Savings Bank	944,420	598,394
Golf Savings Bank	50,661	0
Golf Escrow Company	466	0
Tri-Cities Mortgage Company	32	32
Capital Trust Subsidiaries	7,120	3,282
Receivable from subsidiaries	2,667	3,260
Available for sale investments	42	55
Other assets	2,463	2,366
Total assets	\$ 1,028,927	\$ 623,095
Liabilities and Shareholders' Equity:		
Accrued expenses payable	\$ 8,707	\$ 7,671
Term note payable	0	0
Junior Subordinated Debentures	236,772	108,707
Due to affiliates	32	32
Shareholders' equity	783,416	506,685
Total liabilities and shareholders' equity	\$ 1,028,927	\$ 623,095

**Table of Contents****Sterling Financial Corporation****Notes to Consolidated Financial Statements (Continued)**

	<b>Years Ended December 31,</b>		
	<b>2006</b>	<b>2005</b>	<b>2004</b>
	<b>(In thousands)</b>		
Condensed Statements of Income			
Interest income	\$ 1,520	\$ 748	\$ 626
Interest expense	(14,483)	(8,618)	(8,630)
Net interest expense	(12,963)	(7,870)	(8,004)
Equity in net earnings of subsidiary	84,553	68,339	63,247
Operating expenses	(3,993)	(3,433)	(2,778)
Other noninterest income (expense)	0	0	(238)
Income before income taxes	67,597	57,036	52,227
Income tax benefit	6,349	4,183	4,078
Net income	\$ 73,946	\$ 61,219	\$ 56,305
Condensed Statements of Cash Flows			
Cash flows from operating activities:			
Net income	\$ 73,946	\$ 61,219	\$ 56,305
Adjustments to reconcile net income to net cash used in operating activities	(89,181)	(65,444)	(64,359)
Net cash used in operating activities	(15,235)	(4,225)	(8,054)
Cash flows from investing activities:			
Investments in subsidiaries, net	(118,688)	0	0
Repayment of advances to subsidiaries	7,186	6,484	6,862
Dividends from subsidiary	56,456	11,616	11,616
Cash flows from acquisitions	(26,449)	0	5,152
Other	0	0	3,037
Net cash provided by (used in) investing activities	(81,495)	18,100	26,667
Cash flows from financing activities:			
Proceeds from other borrowings	130,000	0	0
Repayment of other borrowings	(25,475)	(19,000)	(33,000)
Proceeds from exercise of stock options	6,459	3,411	7,083
Dividends paid	(8,895)	(1,736)	0
Other	(9)	(89)	(240)
Net cash provided by (used in) financing activities	102,080	(17,414)	(26,157)



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

Net change in cash and cash equivalents	5,350	(3,539)	(7,544)
Cash and cash equivalents, beginning of year	15,706	19,245	26,789
Cash and cash equivalents, end of year	\$ 21,056	\$ 15,706	\$ 19,245

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.

F-40

---

**Table of Contents****Sterling Financial Corporation****Notes to Consolidated Financial Statements (Continued)**

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, 2006, the bank subsidiary could have declared approximately \$193.7 million of aggregate dividends in addition to amounts previously paid.

**24. Business Combinations:**

During 2006, Sterling completed three acquisitions: 1) FirstBank, 2) Mason-McDuffie Financial Corporation ( Mason-McDuffie ) and 3) Lynnwood. Also during 2006, Sterling entered into a definitive agreement to acquire Northern Empire Bancshares, a California corporation ( Northern Empire ). Below are details of each.

***FirstBank***

On November 30, 2006, Sterling acquired FirstBank, a Washington corporation, by issuing \$15.6 million in cash, and 4,821,913 shares of Sterling common stock valued at \$145.3 million in exchange for all outstanding FirstBank shares. FirstBank options totaling 214,756 were converted into 187,632 Sterling options, valued at \$4.5 million. The total value of the transaction was \$165.4 million. FirstBank merged into Sterling, with Sterling being the surviving corporation in the merger. FirstBank's financial institution subsidiary, FirstBank Northwest, merged with and into Sterling's subsidiary, Sterling Savings Bank, with Sterling Savings Bank being the surviving institution.

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

	<b>Amount</b>
Cash and cash equivalents	\$ 103,971
Investments and MBS	20,851
Loans receivable, net	670,619
Goodwill	102,266
Core deposit intangible	10,935
Other assets	47,930
 Total assets acquired	 \$ 956,572
 Deposits	 \$ 618,677
Other borrowings	157,480
Other liabilities	14,986
 Total liabilities assumed	 791,143
 Net assets acquired	 \$ 165,429



**Table of Contents****Sterling Financial Corporation****Notes to Consolidated Financial Statements (Continued)**

The following summarizes the unaudited pro forma results of operations as if Sterling acquired FirstBank on January 1, 2005 (in thousands, except per share amounts):

	<b>Twelve Months Ended December 31,</b>	
	<b>2006</b>	<b>2005</b>
Pro forma interest income	\$ 605,830	\$ 436,117
Pro forma interest expense	310,621	191,361
Pro forma net interest income	295,209	244,756
Pro forma net income	77,622	64,920
Pro forma earnings per share basic	\$ 1.90	\$ 1.65
Pro forma earnings per share diluted	\$ 1.87	\$ 1.62

***Mason-McDuffie***

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

***Lynnwood***

On July 5, 2006, Sterling completed its acquisition of Lynnwood, the parent company of Golf Savings Bank, by issuing \$15.8 million in cash, and 1,799,961 shares of Sterling common stock valued at \$48.8 million in exchange for all outstanding Lynnwood shares. Lynnwood options totaling 34,662 were converted into 77,258 Sterling options, valued at \$1.7 million. The total value of the transaction was \$66.3 million. Lynnwood merged with and into Sterling, with Sterling being the surviving entity in the merger. Lynnwood's wholly owned subsidiaries, Golf Savings Bank and Golf Escrow Corporation, have become subsidiaries of Sterling. Golf Savings Bank is a Washington state-chartered federally insured savings bank. Golf Savings Bank's primary focus is the origination and sale of residential mortgage loans. Golf Savings Bank's strong mortgage banking operations and construction lending portfolio contributed to Sterling's growth strategy of becoming the leading community bank in the western United States.

**Table of Contents****Sterling Financial Corporation****Notes to Consolidated Financial Statements (Continued)**

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

	<b>Amount</b>
Cash and cash equivalents	\$ 5,732
Investments	3,495
Loans receivable, net	488,188
Goodwill	30,916
Core deposit intangible	696
Other assets	7,236
 Total assets acquired	 \$ 536,263
 Deposits	 \$ 443,427
Other borrowings	19,798
Other liabilities	6,723
 Total liabilities assumed	 469,948
 Net assets acquired	 \$ 66,315

The following summarizes the unaudited pro forma results of operations as if Sterling acquired Lynnwood on January 1, 2005 (in thousands, except per share amounts):

	<b>Year Ended December 31,</b>	
	<b>2006</b>	<b>2005</b>
Pro forma interest income	\$ 575,268	\$ 430,173
Pro forma interest expense	297,325	186,314
 Pro forma net interest income	 277,943	 243,859
Pro forma net income	75,403	68,322
Pro forma earnings per share basic	\$ 2.02	\$ 1.88
Pro forma earnings per share diluted	\$ 2.00	\$ 1.86

***Northern Empire***

On September 17, 2006, Sterling entered into a definitive agreement to acquire Northern Empire Bancshares, a California corporation ( Northern Empire ). Under the terms of the agreement, Northern Empire will be merged with and into Sterling, with Sterling being the surviving corporation in the merger. The agreement also provides that Sterling may elect to merge Northern Empire s financial institution subsidiary, Sonoma National Bank, with and into Sterling s financial institution subsidiary, Sterling Savings Bank, with Sterling Savings Bank being the surviving institution. Under the terms of the agreement, each share of Northern Empire common stock would be converted into 0.8050 shares of Sterling common stock and \$2.71 in cash, subject to certain conditions. The transaction, which was valued at approximately \$335 million, as of the date the parties agreed to merge, is expected to close on February 28, 2007.

F-43