STERLING FINANCIAL CORP /WA/
Form 10-K
March 06, 2009
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# UNITED STATES SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

## FORM 10-K

(Mark One)

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

**For the year ended DECEMBER 31, 2008**

**OR**

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

**For the transition period from to**
**COMMISSION FILE NUMBER 0-20800**

# STERLING FINANCIAL CORPORATION

*(Exact name of registrant as specified in its charter)*

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

111 North Wall Street, Spokane, Washington 99201

(Address of principal executive offices) (Zip code)

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

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

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

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

Common Stock ($1.00 par value)

(Title of class)

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

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 þ

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

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, a non-accelerated filer, or a smaller reporting company. See definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ¨ Accelerated filer þ Non-accelerated filer ¨ Smaller Reporting Company ¨

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

As of June 30, 2008, 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 Global Select Market, was $208 million.

The number of shares outstanding of the registrant s common stock, par value $1.00 per share, as of January 31, 2009 was 52,394,260.

**DOCUMENTS INCORPORATED BY REFERENCE**

Specific portions of the registrant s Proxy Statement for its 2009 annual meeting of shareholders are incorporated by reference into Part III hereof.

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**STERLING FINANCIAL CORPORATION**

**DECEMBER 31, 2008 ANNUAL REPORT ON FORM 10-K**

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## PART I

*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 and Risk Factors.*

## Item 1. Business

### General

Sterling Financial Corporation ( Sterling ) is a bank holding company, organized under the laws of Washington in 1992. The principal operating subsidiaries of Sterling are Sterling Savings Bank and Golf Savings Bank. The principal operating subsidiary of Sterling Savings Bank is INTERVEST-Mortgage Investment Company ( INTERVEST ). During 2008, the operations of Sterling Savings Bank s subsidiary, Action Mortgage Company, were realigned into the real estate division of Sterling Savings Bank, and the operations of Sterling Savings Bank s subsidiary, Harbor Financial Services, Inc., were moved into the wealth management division of Sterling Savings Bank. Sterling Savings Bank commenced operations in 1983 as a Washington State-chartered federally insured stock savings and loan association headquartered in Spokane, Washington. On July 8, 2005, Sterling Savings Bank converted to a commercial bank. The main focus of Golf Savings Bank, a Washington State-chartered savings bank acquired by Sterling in July 2006, is the origination and sale of residential mortgage loans.

Sterling provides personalized, quality financial services and Perfect Fit banking products to its customers consistent with its Hometown Helpful philosophy. Sterling believes that its dedication to personalized service has enabled it to grow both its retail deposit base and its lending portfolio in the western United States. With $12.79 billion in total assets as of December 31, 2008, Sterling originates loans and attracts Federal Deposit Insurance Corporation ( FDIC ) insured and uninsured deposits from the general public through 179 depository banking offices located in Washington, Oregon, California, Idaho and Montana. In addition, Sterling originates loans through Golf Savings Bank and Sterling Savings Bank 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 wealth management 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 and consumer customer relationships that can provide a wider variety of lending opportunities, as well as increasing its commercial and retail deposits, particularly transaction accounts. 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 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 ( Federal Reserve ), the FDIC and the Washington State Department of Financial Institutions ( WDFI ). Sterling s subsidiaries are also subject to regulation by the state agencies for the states in which they conduct business.

Sterling s earnings per share and performance ratios for 2008 were impacted by the major disruption in the housing market and downturn in the economy. During 2008, Sterling recorded a $333.6 million provision for credit losses compared with $25.1 million for 2007, and recorded a $223.8 million non-cash charge to reflect impairment of Sterling s goodwill. Sterling has taken a number of steps to enhance and preserve its capital base and protect customer deposits. Sterling s retail and commercial banking groups continue to perform well, generating net interest income of $359.6 million for 2008 versus $355.4 million for 2007. Sterling remains well capitalized, with excess liquidity, and expects to continue lending to the communities it serves, as well as continue absorbing elevated credit costs.

**Company Growth**

Sterling intends to continue to pursue a long-term growth strategy to become the leading community bank in the western United States, although, with the current economic slow down, growth opportunities may be limited in the near-term. In addition to future organic growth, this long-term strategy may include acquiring other financial businesses or branches thereof, or other substantial assets or deposit liabilities. However, market conditions are having a significant negative impact on the banking industry and there is no assurance that Sterling will be successful at identifying or completing any such acquisitions.

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

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.

**Segment Results**

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

The Community Banking segment provides traditional bank services through the retail and commercial banking and wealth management and administrative division groups of Sterling s subsidiary, Sterling Savings Bank.

The Residential Construction Lending segment originates and services construction loans through the real estate division of Sterling s subsidiary, Sterling Savings Bank.

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

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

During 2008, the operations of Sterling Savings Bank s subsidiary, Action Mortgage Company, were realigned into the real estate division of Sterling Savings Bank, and the operations of Sterling Savings Bank s subsidiary,

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Harbor Financial Services, Inc., were moved into the wealth management division of Sterling Savings Bank. The financial results for the real estate division are reflected in the Residential Construction Lending segment, while the wealth management division s financial results are included in the Community Banking segment. For comparability purposes, prior period segment information has been restated to reflect this realignment.

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, 2008, 2007 and 2006 (in thousands):

| | As of and for the Year Ended December 31, 2008 | | | | | |
|---|---|---|---|---|---|---|
| | Community Banking | Residential Construction Lending | Residential Mortgage Banking | Commercial Mortgage Banking | Other and Eliminations | Total |
| Interest income | $ 565,767 | $ 99,027 | $ 30,559 | $ 18,962 | $ 747 | $ 715,062 |
| Interest expense | (262,637) | (62,492) | (17,570) | 0 | (12,811) | (355,510) |
| Net interest income (expense) | 303,130 | 36,535 | 12,989 | 18,962 | (12,064) | 359,552 |
| Provision for losses on loans | (105,915) | (221,135) | (6,547) | 0 | 0 | (333,597) |
| Noninterest income | 50,757 | 3,234 | 23,572 | 3,803 | (9,258) | 72,108 |
| Noninterest expense | (233,502) | (9,766) | (28,905) | (9,463) | (4,094) | (285,730) |
| Goodwill impairment | (192,695) | 0 | (31,070) | 0 | 0 | (223,765) |
| Income (loss) before income taxes | $ (178,225) | $ (191,132) | $ (29,961) | $ 13,302 | $ (25,416) | $ (411,432) |
| Total assets | $ 10,721,836 | $ 1,526,416 | $ 517,728 | $ 14,958 | $ 9,778 | $ 12,790,716 |

| | As of and for the Year Ended December 31, 2007 | | | | | |
|---|---|---|---|---|---|---|
| | Community Banking | Residential Construction Lending | Residential Mortgage Banking | Commercial Mortgage Banking | Other and Eliminations | Total |
| Interest income | $ 548,815 | $ 185,090 | $ 23,863 | $ 9,000 | $ 210 | $ 766,978 |
| Interest expense | (274,100) | (104,758) | (14,462) | 0 | (18,298) | (411,618) |
| Net interest income (expense) | 274,715 | 80,332 | 9,401 | 9,000 | (18,088) | 355,360 |
| Provision for losses on loans | 11,047 | (35,752) | (383) | 0 | 0 | (25,088) |
| Noninterest income | 81,735 | 6,945 | 21,012 | 7,496 | (23,710) | 93,478 |
| Noninterest expense | (230,825) | (10,395) | (30,584) | (10,970) | (2,763) | (285,537) |
| Income (loss) before income taxes | $ 136,672 | $ 41,130 | $ (554) | $ 5,526 | $ (44,561) | $ 138,213 |
| Total assets | $ 9,999,348 | $ 1,847,344 | $ 399,306 | $ 10,445 | $ (106,668) | $ 12,149,775 |

| | As of and for the Year Ended December 31, 2006 | | | | | |
|---|---|---|---|---|---|---|
| | Community Banking | Residential Construction Lending | Residential Mortgage Banking | Commercial Mortgage Banking | Other and Eliminations | Total |
| Interest income | $ 421,097 | $ 110,781 | $ 11,177 | $ 9,298 | $ (1,498) | $ 550,855 |
| Interest expense | (210,718) | (58,446) | (7,153) | 0 | (10,626) | (286,943) |
| Net interest income (expense) | 210,379 | 52,335 | 4,024 | 9,298 | (12,124) | 263,912 |
| Provision for losses on loans | (14,167) | (4,446) | (90) | 0 | 0 | (18,703) |
| Noninterest income | 58,901 | 7,373 | 11,615 | 6,047 | (14,596) | 69,340 |
| Noninterest expense | (164,133) | (12,601) | (18,091) | (9,101) | (2,447) | (206,373) |

| | | | | | | |
|---|---|---|---|---|---|---|
| Income (loss) before income taxes | $ 90,980 | $ 42,661 | $ (2,542) | $ 6,244 | $ (29,167) | $ 108,176 |
| Total assets | $ 8,299,144 | $ 1,316,763 | $ 308,500 | $ 10,929 | $ (100,844) | $ 9,834,492 |

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**Profitability Drivers**

We expect to return to profitability in the future by:

- Growing our core deposits, particularly commercial, consumer and public sector transaction deposits.
- Expanding full banking relationship products and services for commercial and public sector customers, including depository and treasury management services such as lockbox, on-line net banking, merchant services, analyzed and sweep accounts, remote deposit capture and international services.
- Diversifying and growing our fee income through existing and new fee income sources, including deposit fees, transaction fees, fees from mortgage banking and other fees.
- Improving asset quality through robust underwriting and credit approval functions, and the reduction of non-performing assets.
- Changing the mix of the loan portfolio to increase the volume of higher-yielding commercial banking and consumer loans.
- Managing interest rate risk to protect net interest margin in a changing interest rate environment.
- Controlling expenses and increasing operating efficiency.

Together, we believe these strategies will contribute to a return to 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 ).

**Capital Enhancement**

On December 5, 2008, Sterling completed the sale of 303,000 shares of preferred stock and issued a warrant to purchase 6,437,677 shares of Sterling s common stock to the U.S. Department of the Treasury (the Treasury Department ), raising total proceeds of $303 million. The proceeds are treated as Tier 1 capital. The 303,000 shares of Fixed Rate Cumulative Perpetual Preferred Stock, Series, A, issued by Sterling will pay a cumulative compounding dividend of 5% per year for the first five years and will reset to a rate of 9% per year after five years. After three years, the preferred shares may be redeemed by Sterling at their issue price, plus all accrued and unpaid dividends. Subject to approval by Sterling s banking regulators, the preferred shares may also be redeemed at any time if Sterling chooses to replace them with newly raised equity capital.
In addition to the preferred shares, the Treasury Department received a warrant to purchase 6,437,677 shares of Sterling common stock at an exercise price of $7.06 per share. See Business Regulation, and Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities Stock Market and Dividend Information.

**Lending Activities**

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

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

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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.

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

Sterling s Private Banking Group provides a full line of financial and credit services to higher-net-worth and higher-income borrowers, including a wide 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. The Private Banking Group also serves the needs of the owners and key employees of the commercial and corporate business customers.

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 subsidiary banks 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 are backed by collateral that may be difficult to obtain or liquidate following a default, and it is difficult to accurately predict the borrower s ability to generate future cash flows. These loans, however, typically offer higher yields than residential loans, and variable interest rates. The availability of such loans generally encourages 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 has seen a slowdown in the rate at which newly constructed commercial properties are able to obtain tenants, which has impacted some of its borrowers ability to obtain permanent financing. 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 focuses its residential lending on traditional amortizing loans for owner occupied borrowers, second homes and investment properties per guidelines. Sterling also has interest only loan programs available that are underwritten according to the borrower s ability to make fully amortized payments. To a lesser extent, Sterling originates non-owner occupied residential mortgages. With the recent slowdown in the real estate market, Sterling has experienced an increase in classified and non-performing loans in its non-owner occupied residential loan portfolio.

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

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

Sterling originates residential construction loans on presold and spec homes, as well as townhouses and condominiums and provides land, lot, and acquisition and development loans for residential subdivisions. However, in the current economic environment, the number of viable residential construction projects that meet Sterling s underwriting standards are limited. 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 has seen a deterioration of the credit quality of its residential construction portfolio as evidenced by the increase in classified and non-performing construction loans. Sterling endeavors to limit its risk through its underwriting procedures by using only approved, qualified appraisers and by dealing only with qualified builders/borrowers. See Classified and Non-performing Assets.

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

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

| | Years Ended December 31, 2008 Amount | % | 2007 Amount | % | 2006 Amount | % |
|---|---|---|---|---|---|---|
| | (Dollars in thousands) | | | | | |
| Mortgage: | | | | | | |
| One- to four-family residential | $ 1,464,673 | 40.4 | $ 1,492,026 | 27.2 | $ 830,619 | 16.7 |
| Multifamily residential | 170,975 | 4.7 | 35,870 | 0.7 | 4,215 | 0.1 |
| Commercial real estate | 326,853 | 9.0 | 163,315 | 3.0 | 131,001 | 2.6 |
| Total mortgage loans | 1,962,501 | 54.1 | 1,691,211 | 30.9 | 965,835 | 19.4 |
| Construction: | | | | | | |
| One- to four-family residential | 383,922 | 10.6 | 1,584,449 | 28.9 | 1,425,248 | 28.7 |
| Multifamily residential | 25,374 | 0.7 | 118,799 | 2.2 | 156,932 | 3.2 |
| Commercial real estate | 192,755 | 5.3 | 488,372 | 8.9 | 752,458 | 15.1 |
| Total construction loans | 602,051 | 16.6 | 2,191,620 | 40.0 | 2,334,638 | 47.0 |
| Total mortgage and construction loans | 2,564,552 | 70.7 | 3,882,831 | 70.9 | 3,300,473 | 66.4 |
| Commercial and consumer: | | | | | | |
| Commercial banking | 541,978 | 15.0 | 995,732 | 18.2 | 1,154,304 | 23.2 |
| Consumer direct | 326,763 | 9.0 | 359,338 | 6.6 | 327,027 | 6.6 |
| Consumer indirect | 190,177 | 5.3 | 242,309 | 4.3 | 189,505 | 3.8 |
| Total commercial and consumer loans | 1,058,918 | 29.3 | 1,597,379 | 29.1 | 1,670,836 | 33.6 |
| Total loans originated | $ 3,623,470 | 100.0 | $ 5,480,210 | 100.0 | $ 4,971,309 | 100.0 |

Construction loan originations in 2008 decreased as compared to 2007, reflecting both Sterling s intention to reduce the balance of these loans in its loan portfolio, and current economic conditions that have caused a decline in demand for these loans.

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

| | December 31, | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2008 | | 2007 | | 2006 | | 2005 | | 2004 | |
| | Amount | % | Amount | % | Amount | % | Amount | % | Amount | % |
| | (Dollars in thousands) | | | | | | | | | |
| Mortgage: | | | | | | | | | | |
| One- to four-family residential | $ 867,384 | 9.6 | $ 703,826 | 7.8 | $ 654,661 | 9.2 | $ 488,633 | 9.9 | $ 794,632 | 18.4 |
| Multifamily residential | 477,615 | 5.3 | 389,388 | 4.3 | 263,053 | 3.7 | 332,211 | 6.7 | 184,754 | 4.3 |
| Commercial real estate | 1,364,885 | 15.1 | 1,223,036 | 13.5 | 795,386 | 11.2 | 792,219 | 16.0 | 699,879 | 16.3 |
| Total mortgage loans | 2,709,884 | 30.0 | 2,316,250 | 25.6 | 1,713,100 | 24.1 | 1,613,063 | 32.6 | 1,679,265 | 39.0 |
| Construction: | | | | | | | | | | |
| One- to four-family residential | 1,455,860 | 16.1 | 1,933,125 | 21.3 | 1,429,772 | 20.1 | 591,362 | 11.9 | 356,644 | 8.3 |
| Multifamily residential | 324,818 | 3.6 | 263,873 | 2.9 | 189,819 | 2.7 | 143,272 | 2.9 | 102,166 | 2.4 |
| Commercial real estate | 754,017 | 8.4 | 747,913 | 8.2 | 671,291 | 9.4 | 286,868 | 5.8 | 194,085 | 4.5 |
| Total construction loans | 2,534,695 | 28.1 | 2,944,911 | 32.4 | 2,290,882 | 32.2 | 1,021,502 | 20.6 | 652,895 | 15.2 |
| Total mortgage and construction loans | 5,244,579 | 58.1 | 5,261,161 | 58.0 | 4,003,982 | 56.3 | 2,634,565 | 53.2 | 2,332,160 | 54.2 |
| Commercial and consumer: | | | | | | | | | | |
| Commercial banking | 2,532,158 | 28.1 | 2,639,196 | 29.1 | 2,069,086 | 29.1 | 1,531,079 | 30.9 | 1,311,197 | 30.4 |
| Consumer direct | 859,222 | 9.5 | 798,519 | 8.8 | 749,626 | 10.5 | 618,528 | 12.5 | 543,895 | 12.6 |
| Consumer indirect | 389,298 | 4.3 | 376,937 | 4.1 | 288,704 | 4.1 | 166,143 | 3.4 | 120,894 | 2.8 |
| Total commercial and consumer loans | 3,780,678 | 41.9 | 3,814,652 | 42.0 | 3,107,416 | 43.7 | 2,315,750 | 46.8 | 1,975,986 | 45.8 |
| Total loans receivable | 9,025,257 | 100.0 | 9,075,813 | 100.0 | 7,111,398 | 100.0 | 4,950,315 | 100.0 | 4,308,146 | 100.0 |
| Deferred fees, net | (9,798) | | (16,480) | | (12,308) | | (8,916) | | (6,907) | |
| Gross loans receivable | 9,015,459 | | 9,059,333 | | 7,099,090 | | 4,941,399 | | 4,301,239 | |
| Allowance for loan losses | (208,365) | | (111,026) | | (77,849) | | (52,033) | | (47,352) | |
| Loans receivable, net | $ 8,807,094 | | $ 8,948,307 | | $ 7,021,241 | | $ 4,889,366 | | $ 4,253,887 | |

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***Contractual Principal Payments.*** The following table sets forth the scheduled contractual principal repayments for Sterling s loan portfolio at December 31, 2008. Demand loans, loans having no stated repayment schedule and no stated maturity, and overdrafts are reported as due in one year or less. Loan balances do not include undisbursed loan proceeds, deferred loan origination costs and fees, or allowances for credit losses. The majority of Sterling s construction loans mature in 2009. Sterling s Residential Construction Special Project Team is working closely with these borrowers to identify, manage and resolve credit quality issues, and collect or renew performing loans.

| | Balance Outstanding at December 31, 2008 | | Principal Payments Contractually Due in Fiscal Years (in thousands) | | | | | |
|---|---|---|---|---|---|---|---|---|
| | | | 2009 | | 2010-2013 | | Thereafter | |
| | fixed | variable | fixed | variable | fixed | variable | fixed | variable |
| Mortgage | $ 1,007,259 | $ 1,702,625 | $ 69,885 | $ 146,418 | $ 281,598 | $ 303,838 | $ 655,776 | $ 1,252,369 |
| Construction: | | | | | | | | |
| Residential | 31,707 | 1,424,153 | 26,990 | 1,212,269 | 3,799 | 170,662 | 918 | 41,222 |
| Multifamily | 0 | 324,818 | 0 | 266,593 | 0 | 58,225 | 0 | 0 |
| Commercial | 37,447 | 716,570 | 28,677 | 548,766 | 7,606 | 145,540 | 1,164 | 22,264 |
| Total Construction | 69,154 | 2,465,541 | 55,667 | 2,027,628 | 11,405 | 374,427 | 2,082 | 63,486 |
| Consumer direct | 563,112 | 296,110 | 40,056 | 45,443 | 140,772 | 6,957 | 382,284 | 243,710 |
| Consumer indirect | 389,298 | 0 | 82,658 | 0 | 278,938 | 0 | 27,702 | 0 |
| Commercial banking | 709,934 | 1,822,224 | 242,274 | 780,673 | 281,067 | 293,174 | 186,593 | 748,377 |
| | $ 2,738,757 | $ 6,286,500 | $ 490,540 | $ 3,000,162 | $ 993,780 | $ 978,396 | $ 1,254,437 | $ 2,307,942 |

***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 for 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, 2008 and 2007, Sterling serviced for itself and for other investors, residential mortgage loans totaling $1.29 billion and $1.22 billion, respectively. Of such mortgage loans, $501.6 million in 2008 and $598.5 million in 2007 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, 2008 and 2007, Sterling serviced for itself and other investors, commercial and multifamily real estate loans totaling $3.44 billion and $3.19 billion, respectively.

***Secondary Market Activities.*** Sterling has developed correspondent relationships with a number of mortgage companies and financial institutions to facilitate the origination and sale of mortgage loans in the secondary market on either a participation or whole loan basis. Substantially all of these loans are secured by real estate. On a limited basis, Sterling has purchased mortgage loans in the secondary market. 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. During 2008, Sterling did not purchase any loans in the secondary market.

In 2008 and 2007, nearly all of Sterling s sales of residential mortgage loans were sold into the secondary market on a servicing-released basis. Sterling generally receives a fee of approximately 100 to 200 basis points of the principal balance of mortgage loans for releasing the servicing. For sales of loans on a servicing-retained basis, Sterling records a servicing asset of approximately 100 to 115 basis points of the principal balance. At December 31, 2008 and 2007, Sterling had recorded $5.7 million and $9.0 million in servicing rights, respectively. See Note 5 of Notes to Consolidated Financial Statements.

Sterling, from time to time, sells participations in certain commercial real estate loans to investors on a servicing-retained basis. During the years ended December 31, 2008, 2007 and 2006, Sterling sold approximately $23.0 million, $56.0 million and $54.9 million in loans under participation agreements, resulting in net gains of $109,000, $3.0 million and $747,000, respectively.

***Loan Commitments.*** Sterling makes written commitments to individual borrowers and mortgage brokers for the purposes of originating and purchasing loans. These loan commitments establish the terms and conditions under which Sterling will fund the loans. Sterling had outstanding commitments to originate or purchase loans, the undisbursed portion of which aggregated $809.3 million and $1.40 billion at December 31, 2008 and 2007, respectively. Sterling also had secured and unsecured commercial and personal lines of credit, the undisbursed portion of which was approximately $1.00 billion and $1.13 billion at December 31, 2008 and 2007, respectively. See Note 17 of Notes to Consolidated Financial Statements.

***Derivatives and Hedging.*** As part of its mortgage banking activities, Sterling issues interest rate lock commitments to prospective borrowers on residential mortgage loan applications. Pricing for the sale of these loans is fixed with various qualified investors under both non-binding ( best-efforts ) and binding ( mandatory ) delivery programs. For mandatory delivery programs, Sterling hedges interest rate risk 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 interest rate lock commitments, 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. See Note 10 of Notes to Consolidated Financial Statements.

Interest rate lock commitments and loan delivery commitments are off balance sheet commitments that are considered to be derivatives. As of December 31, 2008, Sterling had $75.4 million of interest rate lock commitments, $71.8 million of warehouse loans held for sale that were not committed to investors and held offsetting forward sale agreements on MBS valued at $114.4 million. In addition, Sterling had mandatory delivery commitments to sell mortgage loans to investors valued at $1.4 million as of December 31, 2008. As of December 31, 2007, Sterling did not have any loans subject to interest rate lock commitments under mandatory delivery programs. As of December 31, 2008 and 2007, Sterling had entered into best efforts forward commitments to sell $71.0 million and $41.3 million of mortgage loans, respectively.

Sterling enters into interest rate swap derivative contracts with customers. The interest rate risk on these contracts is offset by entering into comparable broker dealer swaps. These contracts are carried as an offsetting asset and liability at fair value, and as of December 31, 2008 and 2007, were $7.5 million and $1.6 million, respectively.

***Classified and Non-performing Assets.*** To measure the quality of loans and real estate owned ( REO ), Sterling has established guidelines for classifying and determining provisions for anticipated losses. Sterling s system employs the classification categories of substandard, doubtful and loss for its classified assets. Substandard assets have deficiencies, which give rise to the distinct possibility that Sterling will sustain some loss if the deficiencies are not corrected. Doubtful assets have the weaknesses of substandard assets, and on the basis of currently existing facts, there is a high probability of loss. An asset classified as loss is considered uncollectible and of such little value that it should not be included as an asset of Sterling. Total classified assets increased to $984.9 million at December 31, 2008, from $234.3 million at December 31, 2007. As a percentage of total assets, classified assets increased to 7.70% at December 31, 2008 from 1.93% at December 31, 2007, reflecting the worsening economic conditions, continued stress on real estate values, and credit stress of borrowers.

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The following table describes classified assets by asset type at the dates indicated:

| | December 31, 2008 | September 30, 2008 | June 30, 2008 | March 30, 2008 | December 31, 2007 |
|---|---|---|---|---|---|
| | | | (Dollars in thousands) | | |
| Residential real estate | $ 34,333 | $ 36,863 | $ 21,848 | $ 5,021 | $ 711 |
| Multifamily real estate | 16,741 | 7,313 | 2,289 | 470 | 248 |
| Commercial real estate | 37,890 | 14,931 | 6,390 | 6,277 | 3,224 |
| Construction | | | | | |
| Residential construction | 548,384 | 405,753 | 309,556 | 255,473 | 117,424 |
| Multifamily and commercial construction | 119,348 | 17,109 | 19,042 | 15,182 | 3,566 |
| Total construction | 667,732 | 422,862 | 328,598 | 270,655 | 120,990 |
| Consumer direct and indirect | 4,556 | 4,489 | 3,994 | 2,949 | 2,627 |
| Commercial banking | 143,748 | 130,250 | 111,344 | 104,394 | 95,461 |
| Total classified loans | 905,000 | 616,708 | 474,463 | 389,766 | 223,261 |
| REO | 79,875 | 54,795 | 22,998 | 13,027 | 11,075 |
| Total classified assets | $ 984,875 | $ 671,503 | $ 497,461 | $ 402,793 | $ 234,336 |

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At December 31, 2008, 74% of classified assets are related to construction, the majority of which was residential construction. The commercial construction and commercial banking loan portfolios have also been affected by the downturn in the housing market, with the classified portion of the commercial banking loan portfolio consisting mainly of loans to construction related industries, or lines of credit to developers. Sterling s classified assets as of December 31, 2008, included loans to 20 borrowers that in the aggregate exceeded $15 million to each borrower, and together constitute 48% of classified assets. Additional information regarding the classified assets of these 20 borrowers, sorted by market area, as of December 31, 2008 is provided in the following table:

| Description | December 31, 2008 (Dollars in thousands) | |
|---|---|---|
| Portland and Vancouver | | |
| Acquisition and development: 72 loans | $ | 50,773 |
| Commercial: 3 loans | | 42,048 |
| Acquisition and development, and spec: 89 loans | | 20,193 |
| Acquisition and development, and lots: 15 loans | | 19,559 |
| Single family residential: 12 loans | | 16,656 |
| Acquisition and development, and lots: 2 loans | | 15,439 |
| Total Portland and Vancouver | | 164,668 |
| Southern California | | |
| Acquisition and development, and lots: 2 loans | | 15,696 |
| Acquisition and development, and lots: 2 loans | | 17,895 |
| Acquisition and development, and lots: 1 loan | | 18,360 |
| Acquisition and development: 2 loans | | 23,230 |
| Acquisition and development, and vertical: 8 loans | | 28,027 |
| Total Southern California | | 103,208 |
| Puget Sound | | |
| Single family residential, and lots: 51 loans | | 17,149 |
| Single family residential: 68 loans | | 20,409 |
| Acquisition and development, and lots: 111 loans | | 25,954 |
| Construction line of credit: 2 loans | | 26,607 |
| Total Puget Sound | | 90,119 |
| Other markets | | |
| Multifamily: 13 loans | | 19,441 |
| Residential construction lots: 1 loan | | 16,209 |
| Acquisition and development, and commercial: 2 loans | | 24,525 |
| Multifamily: 1 loan | | 34,439 |
| Acquisition and development, and spec: 21 loans | | 20,503 |
| Total other markets | | 115,117 |
| Total Classified Assets of top 20 borrowers | $ | 473,112 |

As of December 31, 2008, Sterling had charged off approximately $160 million of these loans as confirmed losses. Additionally, Sterling has increased the loan loss provision for the non-impaired classified loans that are included in the calculation of the general loan loss reserve.

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

| | December 31, | | | | |
|---|---|---|---|---|---|
| | 2008 | 2007 | 2006 | 2005 | 2004 |
| | (Dollars in thousands) | | | | |
| Nonaccrual loans | $ 474,172 | $ 123,790 | $ 8,486 | $ 8,701 | $ 14,067 |
| Restructured loans | 56,618 | 350 | 0 | 1,081 | 1,305 |
| Total nonperforming loans | 530,790 | 124,140 | 8,486 | 9,782 | 15,372 |
| Real estate owned | 79,875 | 11,075 | 4,052 | 779 | 1,865 |
| Total nonperforming assets | $ 610,665 | $ 135,215 | $ 12,538 | $ 10,561 | $ 17,237 |
| Total nonperforming assets to total assets | 4.77% | 1.11% | 0.13% | 0.14% | 0.25% |
| Total nonperforming loans to loans | 5.89% | 1.37% | 0.12% | 0.20% | 0.36% |
| Allowance for estimated losses on loans to total nonperforming loans | 39.3% | 89.4% | 917.4% | 531.9% | 321.1% |

Non-performing loans and assets have experienced a greater percentage increase than total assets and loans receivable. As of December 31, 2008, Sterling had recorded a charge-off of $163.9 million on non accrual loans with an aggregate original principal balance of $453.9 million. The remaining balance after charging off a portion of these loans was $290.0 million. If the charge-off amount would have been treated as a specific reserve as it had been in prior years, Sterling s ratio of allowance for estimated losses on loans to non-performing loans would have been 53.6%.

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

| | December 31, | | | | |
|---|---|---|---|---|---|
| | 2008 | 2007 | 2006 | 2005 | 2004 |
| | (Dollars in thousands) | | | | |
| Residential real estate | $ 46,043 | $ 1,557 | $ 1,729 | $ 856 | $ 1,377 |
| Multifamily real estate | 4,757 | 2,268 | 3,356 | 4,302 | 7,696 |
| Commercial real estate | 7,753 | 1,418 | 1,340 | 2,579 | 2,543 |
| Construction: | | | | | |
| Residential | 410,338 | 102,373 | 96 | 0 | 362 |
| Multifamily | 3,894 | 0 | 0 | 0 | 0 |
| Commercial | 70,607 | 3,042 | 0 | 0 | 0 |
| Total construction | 484,839 | 105,415 | 96 | 0 | 362 |
| Consumer direct | 5,053 | 1,716 | 1,069 | 821 | 1,336 |
| Consumer indirect | 700 | 836 | 154 | 164 | 155 |
| Commercial banking | 61,520 | 22,005 | 4,794 | 1,839 | 3,768 |
| Total nonperforming assets | $ 610,665 | $ 135,215 | $ 12,538 | $ 10,561 | $ 17,237 |

Non-performing construction loans made up 79% of non-performing assets at the end of 2008. Residential construction non-performing assets rose $308.0 million during 2008, reflecting the worsening economic conditions, continued stress on real estate values, and credit stress of borrowers. Growth in commercial construction non-performing assets reflects a slowdown in the rate at which newly constructed commercial properties are able to obtain tenants ( lease-ups ). The northern California market, in particular, has experienced a significant decline in lease-ups, which has affected the borrowers cash flows and ability to meet debt service requirements. The increase of non-performing commercial banking loans primarily reflects the impact of the

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current economy on business customers that serve the housing industry. The increase in non-performing loans in the residential portfolio primarily reflects the performance of non-owner occupied loans as a result of a slower lease-up of rental units.

As of December 31, 2008, Sterling had recorded a confirmed loss of $163.9 million on $453.9 million of impaired non-performing loans. The remaining balance after charging off a portion of these loans was $290.0 million. Additionally, as of December 31, 2008 and 2007, Sterling had established a specific credit loss allowance of $2.0 million and $8.7 million on non-performing loans of $6.6 million and $24.5 million, respectively. Non-performing loans that do not have a confirmed loss or specific credit loss allowance have a general credit loss allowance. Sterling regularly reviews the collectability of accrued interest and generally ceases to accrue interest on a loan when either principal or interest is past due by 90 days or more. Any accrued and uncollected interest is reversed from income at that time. Loans may be placed in nonaccrual status earlier if, in management s judgment, the loan may be uncollectible. Interest on such a loan is then recognized as income only if collected or if the loan is restored to performing status. Interest income of $1.3 million, $1.5 million and $249,000 was recorded on these loans during the years ended December 31, 2008, 2007 and 2006, respectively. Additional interest income of $24.1 million, $4.5 million and $321,000 would have been recorded during the years ended December 31, 2008, 2007 and 2006, respectively, if nonaccrual and restructured loans had been current in accordance with their original contractual terms.

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

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

| | Years Ended December 31, | | |
|---|---|---|---|
| | 2008 | 2007 | 2006 |
| | (Dollars in thousands) | | |
| Balance at beginning of period | $ 11,075 | $ 4,052 | $ 779 |
| Loan foreclosures and other additions | 124,610 | 11,418 | 4,998 |
| Loss at foreclosure | (43,710) | (3,166) | (417) |
| Improvements and other changes | (1,819) | 119 | (244) |
| Sales | (10,208) | (1,348) | (894) |
| Provisions for losses | (17,628) | 0 | (170) |
| Balance at end of period | $ 62,320 | $ 11,075 | $ 4,052 |

***Allowance for Credit Losses.*** Sterling performs valuation analysis on its impaired loans. Valuation analysis compares the anticipated fair value (market value less selling costs, foreclosure costs and projected holding costs), and the book balance (loan principal and accrued interest or carrying value of REO). For loans that are considered collateral dependent, the difference between the fair value and the book value is charged off as a confirmed loss. For a non-collateral dependent loan, Sterling establishes a specific reserve for the difference between fair value and book value of these loans, as the loss is not defined as a confirmed loss because it is not based solely on collateral values. Sterling regularly reviews its classified assets for impairment. 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.

Sterling modified its estimate of the fair value of loans being tested for impairment during the fourth quarter of 2008. The fair value is now estimated excluding the potential cash flows from certain guarantors. To the extent that these guarantors are able to provide repayments, a recovery would be recorded upon receipt. In addition to

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the higher credit provision recorded during the fourth quarter of 2008, in many cases, Sterling re-assessed the accounting for real estate loans treated as collateral dependent. As a result, Sterling now considers any impairment on a collateral-dependent loan to be a confirmed loss and charges off the impairment amount when the impairment is identified, rather than establishing a specific allowance on impaired collateral-dependent loans that would have been charged off when foreclosure was probable. As a result of this change, the specific loss allowance was reduced by approximately $163.9 million and is now reflected as part of net charge-offs.

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

Additions to the allowance, in the form of provisions, are reflected in current operating results, while charge-offs to the allowance are made when a loss is determined to be a confirmed loss. Because the allowance for credit losses is based on estimates, ultimate losses may materially differ from the estimates. See Note 4 of Notes to Consolidated Financial Statements.

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

| | Years Ended December 31, | | | | |
|---|---|---|---|---|---|
| | 2008 | 2007 | 2006 | 2005 | 2004 |
| | (Dollars in thousands) | | | | |
| Allowance loans, January 1 | $ 111,026 | $ 77,849 | $ 52,034 | $ 47,352 | $ 34,139 |
| Charge-offs: | | | | | |
| Residential real estate | (6,187) | (30) | (32) | (37) | (59) |
| Multifamily real estate | (1,806) | 0 | 0 | (3) | (2) |
| Commercial real estate | (17,023) | (70) | (902) | (2,315) | (1,824) |
| Construction | (168,471) | (3,430) | (12) | (19) | (645) |
| Consumer direct | (4,053) | (1,268) | (619) | (1,107) | (1,373) |
| Consumer indirect | (5,864) | (1,884) | (823) | (449) | (370) |
| Commercial banking | (19,920) | (1,000) | (2,017) | (5,721) | (1,210) |
| Total charge-offs | (223,324) | (7,682) | (4,405) | (9,651) | (5,483) |
| Recoveries: | | | | | |
| Residential real estate | 66 | 5 | 5 | 6 | 25 |
| Multifamily real estate | 0 | 0 | 0 | 0 | 0 |
| Commercial real estate | 69 | 41 | 157 | 42 | 5 |
| Construction | 221 | 3 | 20 | 0 | 2 |
| Consumer direct | 272 | 261 | 193 | 238 | 214 |
| Consumer indirect | 1,370 | 495 | 310 | 200 | 111 |
| Commercial banking | 80 | 128 | 68 | 86 | 11 |
| Total recoveries | 2,078 | 933 | 753 | 572 | 368 |
| Net charge-offs | (221,246) | (6,749) | (3,652) | (9,079) | (5,115) |
| Provision | 333,597 | 24,838 | 18,703 | 15,200 | 12,150 |
| Acquired | 0 | 15,294 | 13,155 | 0 | 6,722 |
| Transfers | (15,012) | (206) | (2,391) | (1,439) | (544) |
| Allowance loans, December 31 | 208,365 | 111,026 | 77,849 | 52,034 | 47,352 |
| Allowance unfunded commitments, January 1 | 6,306 | 5,840 | 3,449 | 2,010 | 1,466 |
| Provision | 62 | 260 | 0 | 0 | 0 |
| Amounts written off | (46) | 0 | 0 | 0 | 0 |
| Transfers | 15,012 | 206 | 2,391 | 1,439 | 544 |
| Allowance unfunded commitments, December 31 | 21,334 | 6,306 | 5,840 | 3,449 | 2,010 |
| Balance at end of period | $ 229,699 | $ 117,332 | $ 83,689 | $ 55,483 | $ 49,362 |
| Allowances allocated to loans classified as loss | $ 1,980 | $ 8,678 | $ 1,379 | $ 2,159 | $ 3,528 |
| Ratio of net charge-offs to average loans outstanding during the period | 2.37% | 0.08% | 0.06% | 0.20% | 0.13% |

Sterling recorded provisions for credit losses of $333.6 million and $25.1 million for the years ended December 31, 2008 and 2007, respectively. Sterling has increased its provision for credit losses in response to an increase in the level of classified loans and charge offs, particularly in the residential construction portfolio. Similarly, the amount of the provision that is allocated to unfunded commitments has increased due to the percentage increase in loan commitments that relate to loans that are classified.

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The following table sets forth the loan loss allowance by category and summarizes the percentage of total loans in each category to total loans:

| | December 31, | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2008 | | 2007 | | 2006 | | 2005 | | 2004 | |
| | Allowance Amount | Loans in Category as a Percentage of Total Loans | Allowance Amount | Loans in Category as a Percentage of Total Loans | Allowance Amount | Loans in Category as a Percentage of Total Loans | Allowance Amount | Loans in Category as a Percentage of Total Loans | Allowance Amount | Loans in Category as a Percentage of Total Loans |
| | (Dollars in thousands) | | | | | | | | | |
| Residential real estate | $ 8,147 | 9.6 | $ 965 | 7.8 | $ 1,405 | 9.2 | $ 1,039 | 9.9 | $ 1,642 | 18.4 |
| Multifamily real estate | 4,795 | 5.3 | 659 | 4.3 | 671 | 3.7 | 790 | 6.7 | 440 | 4.3 |
| Commercial real estate | 24,720 | 15.1 | 21,244 | 13.5 | 17,565 | 11.2 | 12,748 | 16.0 | 14,185 | 16.3 |
| Construction | 118,279 | 28.1 | 50,109 | 32.4 | 12,098 | 32.2 | 4,566 | 20.6 | 4,254 | 15.2 |
| Consumer direct | 7,207 | 9.5 | 7,274 | 8.8 | 8,205 | 10.5 | 6,795 | 12.5 | 7,247 | 12.6 |
| Consumer indirect | 7,401 | 4.3 | 5,056 | 4.1 | 2,880 | 4.1 | 1,205 | 3.4 | 1,156 | 2.8 |
| Commercial banking | 29,019 | 28.1 | 23,830 | 29.1 | 34,209 | 29.1 | 23,626 | 30.9 | 18,075 | 30.4 |
| Unallocated | 8,797 | N/A | 1,889 | N/A | 816 | N/A | 1,265 | N/A | 353 | N/A |
| | $ 208,365 | 100.0 | $ 111,026 | 100.0 | $ 77,849 | 100.0 | $ 52,034 | 100.0 | $ 47,352 | 100.0 |

During 2008, Sterling s loan loss allowance increased by $97.3 million. The increase was primarily due to the increase in classified and non-performing construction loans. The loan loss allowance allocated to construction loans increased by $68.2 million.

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**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, 2008 and 2007, investments and MBS classified as held to maturity were $175.9 million and $132.8 million, respectively. See MD&A Critical Accounting Policies *Investments and MBS*.

At December 31, 2008 and 2007, investments and MBS classified as available for sale were $2.64 billion and $1.85 billion, respectively. The carrying value of these investments and MBS at December 31, 2008 includes net unrealized losses of $28.4 million, as compared to $28.5 million as of December 31, 2007. 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 the Federal Home Mortgage Corporation ( FHLMC ), the Federal National Mortgage Corporation ( FNMA ) and the Government National Mortgage Association ( GNMA ), and has limited investments in other non-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. Sterling does not invest in collateralized debt obligations or similar exotic structured investment products. See MD&A Results of Operations *Non-Interest Income* and *Non-Interest Expense* and Note 2 of Notes to Consolidated Financial Statements.

The following table provides the carrying values, contractual maturities and weighted average yields of Sterling s investment and MBS portfolio at December 31, 2008. Actual maturities may differ from the contractual maturities, because issuers may have the right to call or prepay obligations with or without prepayment penalties.

| | Less than One Year | One to Five Years | Maturity Over Five to Ten Years (Dollars in thousands) | Over Ten Years | Total |
|---|---|---|---|---|---|
| Mortgage-backed securities | | | | | |
| Balance | $ 0 | $ 61,579 | $ 283,668 | $ 2,074,765 | $ 2,420,012 |
| Weighted average yield | 0.00% | 3.96% | 4.53% | 5.38% | 5.24% |
| Municipal bonds | | | | | |
| Balance | $ 501 | $ 3,072 | $ 21,780 | $ 235,520 | $ 260,873 |
| Weighted average yield[(1)] | 3.13% | 3.33% | 5.41% | 4.71% | 4.75% |
| Short term commercial paper | | | | | |
| Balance | $ 99,117 | $ 0 | $ 0 | $ 0 | $ 99,117 |
| Weighted average yield | 5.81% | 0.00% | 0.00% | 0.00% | 5.81% |
| Other | | | | | |
| Balance | $ 95 | $ 0 | $ 0 | $ 35,023 | $ 35,118 |
| Weighted average yield | 4.55% | 0.00% | 0.00% | 8.33% | 8.30% |
| Total carrying value | $ 99,713 | $ 64,651 | $ 305,448 | $ 2,345,308 | $ 2,815,120 |
| Weighted average yield | 5.79% | 3.93% | 4.59% | 5.28% | 5.19% |

(1) The weighted average yields on municipal bonds reflect the actual yields on the bonds and are not presented on a tax-equivalent basis.

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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:

| | December 31, 2008 | 2007 | 2006 |
|---|---|---|---|
| | (Dollars in thousands) | | |
| Mortgage-backed securities | $ 2,420,012 | $ 1,785,031 | $ 1,687,672 |
| U.S. government and agency obligations | 0 | 9,994 | 22,328 |
| Municipal bonds | 260,873 | 143,063 | 92,808 |
| Short term commercial paper | 99,117 | 0 | 0 |
| Other | 35,118 | 47,976 | 18,941 |
| Total | $ 2,815,120 | $ 1,986,064 | $ 1,821,749 |
| Available for sale | $ 2,639,290 | $ 1,853,271 | $ 1,728,686 |
| Held to maturity | 175,830 | 132,793 | 93,063 |
| Total | $ 2,815,120 | $ 1,986,064 | $ 1,821,749 |
| Weighted average yield | 5.19% | 4.95% | 4.47% |

**Sources of Funds**

***General.*** Sterling s primary sources of funds for use in lending and for other general business purposes are deposits, loan repayments, Federal Home Loan Bank ( FHLB ) 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 wide variety of deposit products and related services to businesses, individuals, public sector entities and other correspondent banks throughout its primary market areas. Deposit accounts include transaction (checking) accounts, savings accounts, money market demand accounts ( MMDA ), and certificates of deposit ( CDs ) accounts. These deposit products and services are marketed by its 179 depository banking offices and each of its private and correspondent banking offices. Sterling offers both interest- and non-interest-bearing checking accounts that may 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, most 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 competes with other financial institutions and financial intermediaries in attracting deposits. There is strong competition for transaction, money market and time deposit balances from commercial banks, credit unions and nonbank corporations, such as securities brokerage companies, mutual funds and other diversified companies, some of which have nationwide networks of offices. Much of Sterling s marketing efforts have been directed toward attracting additional deposit customer relationships and balances. Sterling provides electronic banking products, including debit card, online Internet banking, bill pay, merchant services and treasury management services, which include remote deposit capture. All of these products and services are intended to enhance customer relationships and attract and increase retail deposit balances.

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Sterling has 163 automated teller machines ( ATM ). Customers also can access ATMs operated by other financial institutions. Sterling is a member of the Plus System ATM network that allows participating customers to deposit or withdraw funds from transaction accounts, MMDA and savings accounts at numerous locations in the United States and internationally.

Sterling supplements its retail deposit gathering by soliciting funds from public entities and acquiring brokered deposits. Public funds are generally obtained by competitive bidding among qualifying financial institutions. Public funds were 10% and 5% of deposits at December 31, 2008 and 2007, respectively. Brokered deposits were 18% and 14% of deposits at December 31, 2008 and 2007, respectively. In 2009, certain states have either increased or proposed to increase the collateralization requirements for uninsured public funds. The increased collateralization requirements could result in public funds being a less attractive funding source for Sterling in the future.

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, | | | | | |
|---|---|---|---|---|---|---|
| | 2008 | | 2007 | | 2006 | |
| | Average Balance | Weighted Average Interest Rate | Average Balance | Weighted Average Interest Rate | Average Balance | Weighted Average Interest Rate |
| | (Dollars in thousands) | | | | | |
| Transaction accounts: | | | | | | |
| Interest-bearing | $ 441,708 | 0.31% | $ 463,337 | 0.55% | $ 399,690 | 0.42% |
| Noninterest-bearing | 880,224 | 0.00 | 895,729 | 0.00 | 706,631 | 0.00 |
| Savings and MMDA | 2,173,133 | 2.13 | 2,078,984 | 3.45 | 1,512,198 | 3.16 |
| Time deposits | 4,553,160 | 4.10 | 4,039,152 | 5.04 | 2,962,017 | 4.58 |
| | $ 8,048,225 | 2.91% | $ 7,477,202 | 3.71% | $ 5,580,536 | 3.32% |

The following table shows the amounts and remaining maturities of time deposits that had balances of $100,000 or more at December 31, 2008 and 2007:

| | December 31, | |
|---|---|---|
| | 2008 | 2007 |
| | (Dollars in thousands) | |
| Three months or less | $ 535,399 | $ 637,425 |
| After three months through six months | 297,665 | 326,415 |
| After six months through twelve months | 648,334 | 404,888 |
| After twelve months | 253,489 | 140,005 |
| | $ 1,734,887 | $ 1,508,733 |

***Borrowings.*** Deposit accounts are Sterling s primary source of funds. Sterling does, however, use wholesale funds to supplement its funding and to meet deposit withdrawal requirements. These borrowings include advances from the FHLB, reverse repurchase agreements, primary credits and term auction facilities from the Federal Reserve, as well as federal funds purchased. Other borrowings decreased during 2008 as a result of Sterling s redemption on January 25, 2008 of $24.0 million of Trust Preferred Securities that carried a 10.25% fixed-rate coupon. See MD&A Liquidity and Capital Resources.

The FHLB of Seattle is part of a system that consists of 12 regional Federal Home Loan Banks that provide credit to financial institutions. As a condition of membership in the FHLB of Seattle, Sterling s subsidiary banks are required to own stock of the FHLB of Seattle in an amount determined by a formula based upon the larger of

their total qualifying mortgages and MBS, or total advances from the FHLB of Seattle. At December 31, 2008, Sterling Savings Bank and Golf Savings Bank held more than the minimum FHLB of Seattle stock ownership requirement.

As members of the FHLB of Seattle, Sterling Savings Bank and Golf 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, 2008, Sterling had advances totaling $1.59 billion from the FHLB of Seattle, which mature from 2009 through 2033. At December 31, 2008, the interest rates ranged from 0.13% to 8.08%. Additionally, as of December 31, 2008, Sterling had $133.2 million of advances from the FHLB of San Francisco, which were assumed in the Northern Empire acquisition. Sterling does not anticipate additional advances from this source.

The economic difficulties that have plagued the financial markets during 2008 had a significant impact on the Federal Home Loan Banks. Given the negative impacts from other-than-temporary impairment ( OTTI ) charges on certain non-agency MBS and the current market uncertainty, both the FHLB of Seattle and the FHLB of San Francisco announced that they would cease paying dividends and would not redeem or repurchase capital stock. Both the FHLB of Seattle and the FHLB of San Francisco also announced that they would monitor their capital levels, the OTTI issue, overall financial performance and developments in the financial markets as a basis for determining the status of dividends and capital stock redemptions or repurchases in future quarters. The FHLB of Seattle, Sterling s current source of FHLB advances, continues to provide Sterling with a readily available source of liquidity, although there can be no assurance that this will always be the case. See MD&A Liquidity and Capital Resources and Note 9 of Notes to Consolidated Financial Statements.

Sterling also borrows funds under reverse repurchase agreements with major broker/dealers and financial entities pursuant to which it sells investments (generally, U.S. agency obligations and MBS) under an agreement to buy them back at a specified price at a later date. These agreements to repurchase are deemed to be borrowings collateralized by the investments and MBS sold. Sterling uses these borrowings to supplement deposit gathering for funding the origination of loans. Sterling had $1.09 billion and $1.03 billion in wholesale and retail reverse repurchase agreements outstanding at December 31, 2008 and 2007, respectively. The use of reverse repurchase agreements may expose Sterling to certain risks not associated with other borrowings, including IRR and the possibility that additional collateral may have to be provided if the market value of the pledged collateral declines. For additional information regarding reverse repurchase agreements, see MD&A Asset and Liability Management, MD&A Liquidity and Capital Resources and Note 10 of Notes to Consolidated Financial Statements.

As of December 31, 2008 and 2007, Sterling also had $69.0 million and $151.7 million, respectively, of federal funds purchased and funds from the Federal Reserve discount window, which are short term borrowings from correspondent banks and the Federal Reserve. The market for federal funds purchased experienced a decrease in liquidity, given the credit and interbank lending conditions of 2008, while funds from the Federal Reserve became more attractive. During the first quarter of 2008, in an effort to increase liquidity in the banking system, the Federal Reserve lowered the rate of funds available from its discount window to 25 basis points above the federal funds target rate, lengthened the term of these funds and broadened the range of collateral that it was willing to accept. Sterling has utilized this source of funds to the extent that these funds are more competitive than other sources.

In September 2008, Sterling terminated its revolving credit agreement with Wells Fargo Bank, N.A. because Sterling had not used the facility during 2008 and the cost of maintaining the facility outweighed the benefit of having it available.

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

| | Years Ended December 31, 2008 | 2007 | 2006 |
|---|---|---|---|
| | (Dollars in thousands) | | |
| Maximum amount outstanding at any month-end during the period: | | | |
| Short-term reverse repurchase agreements and funds purchased | $ 118,343 | $ 288,845 | $ 235,495 |
| Short-term advances | 594,614 | 826,045 | 803,307 |
| Average amount outstanding during the period: | | | |
| Short-term reverse repurchase agreements and funds purchased | $ 100,924 | $ 158,852 | $ 160,702 |
| Short-term advances | 444,806 | 539,635 | 674,929 |
| Weighted average interest rate paid during the period: | | | |
| Short-term reverse repurchase agreements and funds purchased | 1.51% | 4.62% | 4.64% |
| Short-term advances | 3.76% | 5.19% | 4.44% |
| Weighted average interest rate paid at end of period: | | | |
| Short-term reverse repurchase agreements and funds purchased | 2.03% | 4.31% | 4.81% |
| Short-term advances | 3.87% | 4.48% | 5.14% |

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

| | December 31, 2008 Amount | % | 2007 Amount | % | 2006 Amount | % |
|---|---|---|---|---|---|---|
| | (Dollars in thousands) | | | | | |
| FHLB advances: | | | | | | |
| Short-term | $ 548,819 | 17.5 | $ 399,617 | 12.7 | $ 803,307 | 37.1 |
| Long-term | 1,177,730 | 37.5 | 1,288,372 | 41.0 | 505,310 | 23.3 |
| Securities sold subject to reverse repurchase agreements and funds purchased: | | | | | | |
| Short-term | 163,023 | 5.2 | 288,845 | 9.2 | 86,354 | 4.0 |
| Long-term | 1,000,000 | 31.9 | 890,000 | 28.4 | 530,000 | 24.5 |
| Trust Preferred Securities | 245,276 | 7.8 | 270,015 | 8.6 | 236,772 | 10.9 |
| Other | 3,000 | 0.1 | 3,000 | 0.1 | 3,454 | 0.2 |
| Total borrowings | $ 3,137,848 | 100.0 | $ 3,139,849 | 100.0 | $ 2,165,197 | 100.0 |
| Weighted average interest rate at end of period | | 3.34% | | 4.63% | | 5.17% |

**Subsidiaries**

Sterling s principal operating subsidiaries are Sterling Savings Bank and Golf Savings Bank. Sterling Savings Bank s principal subsidiary is INTERVEST. 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 III ( SCT-III ) was organized in April 2003 as a Delaware business trust. Sterling owns all the common equity of SCT-III. The sole asset of SCT-III is the Junior Subordinated Debentures-III issued by Sterling. See Note 11 of Notes to Consolidated Financial Statements.

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

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

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

(6) 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 11 of Notes to Consolidated Financial Statements.

(7) 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 11 of Notes to Consolidated Financial Statements.

(8) Sterling Capital Trust IX ( SCT-IX ) was organized in July 2007 as a Delaware business trust. Sterling owns all the common equity of SCT-IX. The sole asset of SCT-IX is the Junior Subordinated Debentures-IX issued by Sterling. See Note 11 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 11 of Notes to Consolidated Financial Statements.

(10) Lynnwood Financial Statutory Trust I ( LCT-I ) was organized in March 2004 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 11 of Notes to Consolidated Financial Statements.

(11) Lynnwood Financial Statutory Trust II ( LCT-II ) was organized in June 2006 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 11 of Notes to Consolidated Financial Statements.

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

***Sterling Savings Bank.***

(1) Action Mortgage Company was organized to originate residential loans. During 2008, its operations were realigned into the real estate division of Sterling Savings Bank.

(2) The Dime Service Corporation was acquired as part of a merger in February 2004.

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

(4) Evergreen First Service Corporation owns all of the outstanding capital stock of Harbor Financial. During 2008, Harbor Financial s operations were moved into the wealth management division of Sterling Savings Bank.

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

(6) Mason-McDuffie conducts mortgage banking operations.

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

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

(9) 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 commercial banks, savings and loan associations, mutual savings banks, credit unions 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, 2008, Sterling, including its subsidiaries, had 2,481 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*

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*under review by Congress and state legislatures, and federal and state regulatory agencies. A change in statutes, regulations or regulatory policies applicable to Sterling, including changes in interpretation or implementation thereof, could have a material effect on Sterling s business.*

***General***

Sterling is a bank holding company and as such is subject to comprehensive examination and regulation by the Federal Reserve. 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 WDFI. Furthermore, certain transactions and savings deposits are subject to regulations and controls promulgated by the Federal Reserve. Sterling s subsidiaries are also subject to regulation by the 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.

***Recent Legislative and Regulatory Initiatives to Address Financial and Economic Crises.*** The U.S. Congress, the U.S. Department of the Treasury (the Treasury Department ) and the federal banking regulators, including the FDIC, have taken broad action since early September 2008 to address volatility in the U.S. banking system.

In October 2008, the Emergency Economic Stabilization Act of 2008 ( EESA ) was enacted. The EESA authorizes the Treasury Department to purchase from financial institutions and their holding companies up to $700 billion in mortgage loans, mortgage-related securities and certain other financial instruments, including debt and equity securities issued by financial institutions and their holding companies in a troubled assets relief program ( TARP ). EESA also increased FDIC deposit insurance on most accounts from $100,000 to $250,000.

The purpose of TARP is to restore confidence and stability to the U.S. banking system and to encourage financial institutions to increase their lending to customers and to each other. The Treasury Department initially allocated $250 billion towards the TARP Capital Purchase Program ( CPP ). Under the CPP, the Treasury Department purchases debt or equity securities from participating institutions. The TARP also allows for direct purchases or guarantees of troubled assets of financial institutions. Participants in the CPP are subject to executive compensation limits and are encouraged to expand their lending and mortgage loan modifications. On December 5, 2008, Sterling completed the sale of 303,000 shares of preferred stock and issued a warrant to purchase 6,437,677 shares of Sterling s common stock to the U.S. Department of the Treasury, raising total proceeds of $303 million. In connection with Sterling s participation in the CPP, certain executive officers of Sterling have entered into amended employment agreements with Sterling.

Following a determination that the banking industry faced systemic risk, the FDIC established a Temporary Liquidity Guarantee Program ( TLGP ) on October 14, 2008. The TLGP includes the Transaction Account Guarantee Program ( TAGP ), which provides unlimited deposit insurance coverage through December 31, 2009 for non-interest-bearing transaction accounts (typically business checking accounts) and certain funds swept into non-interest-bearing savings accounts. Institutions participating in the TAGP pay a 10 basis points fee (annualized) on the balance of each covered account in excess of $250,000, while the extra deposit insurance is in place. The TLGP also includes the Debt Guarantee Program ( DGP ), under which the FDIC guarantees certain senior unsecured debt of FDIC-insured institutions and their holding companies. The unsecured debt must be issued on or after October 14, 2008 and not later than June 30, 2009, and the guarantee is effective through the earlier of the maturity date or June 30, 2012. The DGP coverage limit is generally 125% of the eligible entity s eligible debt outstanding on September 30, 2008 and scheduled to mature on or before June 30, 2009 or, for certain insured institutions, 2% of their liabilities as of September 30, 2008. Depending on the term of the debt maturity, the nonrefundable DGP fee ranges from 50 to 100 basis points (annualized) for covered debt outstanding until the earlier of maturity or June 30, 2012. The TAGP and DGP are in effect for all eligible entities, unless the entity opted out on or before December 5, 2008. Sterling has elected to participate in the TLGP and DGP. As of December 31, 2008, Sterling had not issued unsecured debt guaranteed by the DGP.

In February 2009, the American Recovery and Reinvestment Act of 2009 ( ARRA ) was enacted. Among other things, the ARRA more strictly limits the payment of incentive compensation and any severance or golden parachute payments to certain highly compensated employees of institutions that participate in the CPP. The ARRA also expands the scope of employees who are subject to a clawback of bonus and incentive compensation that is based on results that are later found to be materially inaccurate, adds additional corporate governance requirements, and requires the Treasury Department to perform a retroactive review of compensation to the five highest compensated employees of all CPP participants.

***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 ( SOX ) was enacted in response to public concerns regarding corporate accountability. The stated goals of SOX 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. SOX represents a comprehensive revision of laws affecting corporate governance, accounting obligations and corporate reporting. SOX generally applies to all companies that file or are required to file periodic reports with the Securities and Exchange Commission ( SEC ) under the Securities Exchange Act of 1934, as amended ( Exchange Act ).

SOX 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, SOX 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 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. The GLBA allows financial institutions to 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. Sterling files annual reports of operations with the Federal Reserve.

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 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 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, it may engage de novo in certain permissible non-banking activities without prior Federal Reserve 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 with 60 days prior written notice of the proposed acquisition. Following receipt of this notice, the Federal Reserve has 60 days within which to issue a notice disapproving the proposed acquisition, but the Federal Reserve 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 issues written notice of its intent not to disapprove the transaction. In addition, any company must obtain the Federal Reserve s approval before acquiring 25% (5% if the company is a bank holding company) or more of the outstanding shares or otherwise obtaining control over Sterling.

***The Federal Reserve Act.*** Sterling and its subsidiaries are deemed affiliates within the meaning of the Federal Reserve Act, and transactions between affiliates are subject to certain restrictions. Accordingly, Sterling and its subsidiaries must comply with Sections 23A and 23B of the Federal Reserve Act. 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. Section 23A includes a number of exemptions for certain transactions between banks and their affiliates. The most important exemption is for transactions that are between banks where 80 percent or more of each bank s stock is owned by the same company.

*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 subsidiaries. This means that Sterling is required to commit, as necessary, resources to support Sterling Savings Bank and Golf 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 WDFI. 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.

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

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

***Lending Restrictions and Disclosure Requirements.*** The Federal Reserve 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.*** During 2006, the FDIC merged the Bank Insurance Fund ( BIF ) and the Savings Association Insurance Fund ( SAIF ) into a new Deposit Insurance Fund ( DIF ). The DIF and FDIC insure deposits of Sterling Savings Bank and Golf Savings Bank up to the prescribed limits for each depositor. In October 2008, the basic limit on federal deposit insurance coverage of interest bearing transaction accounts increased from $100,000 to $250,000 per depositor under the EESA. In November 2008, the FDIC offered a voluntary expanded insurance program to depository institutions, which provides, without charge to depositors, full guarantee on all non-interest bearing transaction accounts held by any depositor, regardless of dollar amount. Sterling Savings Bank and Golf Savings Bank are participating in this program. 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 a company s FDIC supervisory rating, and other various measures, such as the level of brokered deposits, unsecured debt, and debt issuer ratings.

On February 27, 2009, the FDIC adopted an amended Restoration Plan for the DIF that was originally established and implemented on October 7, 2008. The amended Plan requires an increase in premium assessment rates to return the DIF reserve ratio to 1.15 percent within seven years. The FDIC also adopted an interim rule imposing a special assessment equal to 20 basis points of an institution s assessment base on June 30, 2009. The assessment will be payable on or about September 30, 2009. The interim rule provides that the FDIC may impose additional emergency special assessments of up to 10 basis points, if necessary. There can be no assurance as to what the amount of the assessment rates will be when the final rule is adopted.

The DIF assessment rate currently ranges from 12 to 50 cents per $100 of domestic deposits. Effective April 1, 2009, the FDIC has proposed an assessment rate range of 12 to 45 basis points for institutions that do not exceed a certain threshold amount of brokered deposits and secured liabilities, and higher rates for those that do exceed the threshold amount. The FDIC may increase or decrease the assessment rate schedule 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.

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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, which are referred to as FICO bonds, were issued to capitalize the Federal Savings and Loan Insurance Corporation. FDIC-insured depository institutions paid between 1.10 cents to 1.14 cents per $100 of DIF-assessable deposits in 2008. The FDIC established the FICO assessment rate effective for the first quarter of 2009 at approximately 1.14 cents annually per $100 of assessable deposits.

***Dividends Restrictions.*** Sterling is a legal entity separate and distinct from its subsidiary banks and other subsidiaries. Its principal source of funds to pay dividends on its common and preferred stock and principal and interest on its debt is dividends from its subsidiaries. Various federal and state statutory provisions and regulations limit the amount of dividends Sterling Savings Bank, 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 Federal Reserve, 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, 2008, 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 12 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 WDFI, 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 WDFI are generally no stricter than the liquidity and other requirements set by the Federal Reserve. 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 WDFI 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 WDFI 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 depository branches within the states of Oregon, Idaho, California 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, the California Department of Financial Institutions and the Montana Department of Finance, as applicable. Golf Savings Bank s only depository branch is located in the state of Washington. Sterling and its subsidiaries are also required to comply with applicable laws and regulations for activities in Arizona, Utah and Colorado. In addition, Golf Savings Bank is also required to comply with applicable laws and regulations for activities in Oregon, Idaho, Utah and Montana.

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***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 credit losses and hybrid capital instruments. The sum of Tier I capital and Tier II capital represents an institution s total capital. The guidelines require that at least 50% of an institution s total capital consist of Tier I capital.

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

***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, antic 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;

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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;

the financial condition of Sterling s borrowers and lenders;

Sterling s success in gaining regulatory approvals, when required;

technological and management changes;

growth and acquisition strategies;

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

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

changes in consumer spending and saving habits;

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

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

**Where You Can Find More Information**

The periodic reports Sterling files with the SEC are available on Sterling s website at www.sterlingfinancialcorporation-spokane.com after the reports are filed with the SEC. The SEC maintains a website located at 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

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## 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.*

**Current market developments have adversely affected our industry, business, results of operations and access to capital and may continue to do so.**

Dramatic declines in the housing market over the past year, with falling home prices and increasing foreclosures and unemployment, have resulted in significant write-downs of asset values by financial institutions, including government-sponsored entities as well as major commercial and investment banks. These write-downs, initially of mortgage-backed securities but spreading to credit default swaps and other derivative securities, in turn have caused many financial institutions to seek additional capital, to merge with larger and stronger institutions and, in some cases, to fail. Reflecting concern about the stability of the financial markets generally and the strength of counterparties, many lenders and institutional investors have restricted lending to even the most credit-worthy borrowers or to other financial institutions and government agencies. The resulting economic pressure on consumers and lack of confidence in the financial markets has adversely affected our business, financial condition and results of operations. We do not expect that the difficult conditions in the financial markets are likely to improve in the near future. If market conditions continue to worsen, they would likely have adverse effects on us and other financial institutions. In particular, we may face the following risks in connection with these events:

- The processes we use to estimate inherent losses may no longer be reliable because they rely on complex judgments, including forecasts of economic conditions, which may no longer be capable of accurate estimation.

- Our ability to assess the creditworthiness of our customers may be impaired if the models and approaches we use to select, manage, and underwrite our customers become less predictive of future charge-offs.

- The values of our real estate collateral supporting many construction, land acquisition, multifamily and commercial loans and home mortgages have declined and may continue to decline.

- Our ability to borrow from other financial institutions or to engage in securitization funding transactions on favorable terms or at all could be adversely affected by further disruptions in the capital markets or other events, including actions by rating agencies and deteriorating investor expectations.

- We may be required to pay significantly higher FDIC premiums because market developments have significantly depleted the insurance fund of the FDIC and reduced the ratio of reserves to insured deposits.

- Competition in our industry for deposits and quality loans has increased significantly and could intensify as a result of the increasing consolidation of financial services companies in connection with current market conditions.

- We expect to face increased regulation of our industry. Compliance with such regulation may increase our costs, limit our ability to pursue business opportunities, and increase compliance challenges.

- Market developments may affect consumer confidence levels and may cause declines in credit card usage and adverse changes in payment patterns, causing increases in delinquencies and default rates.

**Current levels of market volatility are unprecedented.**

The capital and credit markets have been experiencing volatility and disruption for more than 12 months. In recent weeks, the volatility and disruption has reached unprecedented levels. In some cases, the markets have

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produced downward pressure on stock prices and credit availability for certain issuers without regard to those issuers underlying financial strength. If current levels of market disruption and volatility continue or worsen, there can be no assurance that we will not experience an adverse effect, which may be material, on our ability to access capital and on our business, financial condition and results of operations.

**The soundness of other financial institutions could adversely affect us.**

Our ability to engage in routine funding transactions could be adversely affected by the actions and commercial soundness of other financial services institutions, including the Federal Home Loan Bank of Seattle. Financial services institutions are interrelated as a result of trading, clearing, counterparty, or other relationships. We have exposure to many different industries and counterparties, and we routinely execute transactions with counterparties in the financial services industry, including brokers and dealers, commercial banks, investment banks, mutual and hedge funds, and other institutional clients, resulting in a significant credit concentration with respect to the financial services industry overall. As a result, defaults by, or even rumors or questions about, one or more financial services institutions, or the financial services industry generally, have led to market-wide liquidity problems and could lead to losses or defaults by us or by other institutions.

Sterling solicits public deposits in various states, including Washington and Oregon. As a Washington and Oregon Public Depositary, Sterling is part of a collateral pool established to protect public deposits not covered by FDIC insurance or assets of a failed bank. Sterling can be assessed its prorata share of public fund losses resulting from the failure of another bank in the collateral pool. In February 2009, Sterling was assessed $1.1 million for its prorata share of a public fund loss resulting from the recent failure of a Washington State Public Depositary Bank. Washington State Public Depositaries are currently required to collateralize 10% of their Washington State Uninsured Public Funds. On February 18, 2009, the Washington State Public Deposit Protection Commission adopted a resolution that sets a July 1, 2009 target for all banks and thrifts that operate as public depositaries to collateralize 100% of their uninsured public deposits. The Washington State Legislature in conjunction with the State Treasurer and DFI is working on legislation updates to improve the risk management and communication between units of government and to take other steps to reduce the risk to pool participants. Oregon State Public Depositaries are currently required to collateralize Oregon Public Uninsured deposits at either 10% or 110%, at the option of the Oregon State Treasurer. Sterling is currently taking steps to limit its exposure to public fund losses, although their can be no guarantee that Sterling will be successful at limiting such exposure.

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

Increased delinquencies or loan defaults by Sterling s customers may further 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. Recently, Sterling has experienced an increase in the level of delinquencies and non-performing loans, primarily, within its construction portfolio. This has adversely affected Sterling s recent financial performance and may continue to do so until economic trends improve.

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 credit 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 credit losses, which could have a material adverse effect on its operating results. Recently,

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Sterling has increased its provision for credit losses in response to an increase in the level of classified and non-performing loans, as well as declines in real estate values.

Sterling makes various assumptions and judgments about the collectability 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 credit losses. If Sterling s assumptions prove to be incorrect, its allowance for credit 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 credit 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, credit losses could occur that are not incorporated in the existing allowance for credit losses.

**We may be required to repurchase mortgage loans in some circumstances, which could harm our liquidity, results of operations and financial condition.**

When we sell mortgage loans, whether as whole loans or pursuant to a securitization, we are required to make customary representations and warranties to the purchaser about the mortgage loans and the manner in which they were originated. Our whole loan sale agreements require us to repurchase or substitute mortgage loans in the event we breach any of these representations or warranties. In addition, we may be required to repurchase mortgage loans as a result of borrower fraud or in the event of early payment default of the borrower on a mortgage loan. Likewise, we are required to repurchase or substitute mortgage loans if we breach a representation or warranty in connection with our securitizations. The remedies available to us against the originating broker or correspondent may not be as broad as the remedies available to a purchaser of mortgage loans against us, and we face the further risk that the originating broker or correspondent may not have the financial capacity to perform remedies that otherwise may be available to us. Therefore, if a purchaser enforces its remedies against us, we may not be able to recover our losses from the originating broker or correspondent. If repurchase and indemnity demands increase, our liquidity, results of operations and financial condition will be adversely affected.

**Recent governmental actions to help stabilize the U.S. financial system or improve the housing market may not be successful.**

The actual impact of the EESA and other governmental actions that have been taken to alleviate the credit crisis is unknown, and may contribute to the extreme levels of volatility and limited credit availability currently being experienced in the economy. The failure of such measures to help stabilize the financial markets and a continuation or worsening of current market conditions could materially and adversely affect Sterling s business, financial condition, results of operations, access to credit or the trading price of Sterling s common stock.

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

A continued 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 and secured by Pacific Northwest real estate, other assets or real estate in other markets in the western United States. 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 and Portland, Oregon, as well as in Sterling s other markets throughout the western United States, including: Spokane, Washington; Boise, Idaho; Bend, Oregon; Sacramento and Los Angeles, California; and Phoenix, Arizona.

Any adverse economic or business developments or natural disasters in these areas could cause uninsured damage and other loss of value to real estate that secures Sterling loans or could negatively affect the ability of borrowers to make payments of principal and interest on the underlying loans. In the event of such adverse development or natural disaster, Sterling s results of operations or financial condition could be adversely affected.

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

**We may experience future goodwill impairment.**

For the year ended December 31, 2008, Sterling recorded a non-cash charge to reflect impairment of Sterling s goodwill as a result of a number of factors, including the sustained and protracted decline in Sterling s stock price and market capitalization. If our estimates of the fair value of our goodwill change as a result of changes in our business or other factors, we may determine that another impairment charge is necessary. Estimates of fair value are based on a complex model using, among other things, cash flows and company comparisons. If our estimates of future cash flows or other components of our fair value calculations are inaccurate, the fair value of goodwill reflected in our financial statements could be inaccurate and we could be required to take additional impairment charges, which could have a material adverse effect on our results of operations and financial condition.

**Liquidity risk could impair our ability to fund operations and jeopardize our financial condition.**

Liquidity is essential to our business. An inability to raise funds through deposits, borrowings, the sale of loans and other sources could have a substantial negative effect on our liquidity. Our access to funding sources in amounts adequate to finance our activities on terms which are acceptable to us could be impaired by factors that affect us specifically or the financial services industry or economy in general. Factors that could detrimentally impact our access to liquidity sources include a decrease in the level of our business activity as a result of a continued downturn in the markets in which our loans are concentrated or adverse regulatory action against us. Our ability to borrow could also be impaired by factors that are not specific to us, such as a disruption in the financial markets or negative views and expectations about the prospects for the financial services industry in light of the recent turmoil faced by financial institutions and the continued deterioration in credit markets.

**We may elect or be compelled to seek additional capital in the future, but that capital may not be available when it is needed.**

We are required by federal and state regulatory authorities to maintain adequate levels of capital to support our operations. In addition, we may elect to raise additional capital to support our business or to finance acquisitions, if any, or we may otherwise elect or be required to raise additional capital. In that regard, a number of financial institutions have recently raised considerable amounts of capital in response to a deterioration in their results of operations and financial condition arising from the turmoil in the mortgage loan market, deteriorating economic conditions, declines in real estate values and other factors. Should we be required by regulatory authorities to raise additional capital, we may seek to do so through the issuance of, among other things, our common stock or preferred stock.

Our ability to raise additional capital, if needed, will depend on conditions in the capital markets, economic conditions and a number of other factors, many of which are outside our control, and on our financial performance. Accordingly, we cannot assure you of our ability to raise additional capital if needed or on terms acceptable to us. If we cannot raise additional capital when needed, it may have a material adverse effect on our financial condition, results of operations and prospects.

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

Sterling is increasing its commercial and consumer lending while placing an increased emphasis on attracting greater volumes of retail deposits. Commercial and consumer 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.

Commercial 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 this area. 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 and consumer 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 construction loans. At December 31, 2008 and 2007, $2.53 billion and $2.94 billion of Sterling Savings Bank s total loan portfolio, respectively, consisted of construction loans. Approximately 52% and 57% of Sterling s construction loans were for speculative endeavors as of December 31, 2008 and 2007, respectively. 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. Recently, several of Sterling s markets have experienced negative market conditions that have adversely affected the marketing and valuations of residential housing under construction and Sterling has experienced an increase in the level of non-performing loans within its residential construction portfolio. As of December 31, 2008 and 2007, non-performing residential constructions loans totaled $410.3 million and $100.8 million, respectively, of which Portland, Oregon, the Puget Sound in Washington State, and Southern California accounted for a combined 63% and 36%, respectively.

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Additionally, at December 31, 2008 and 2007, 20% and 18%, respectively, 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. Further declines in real estate values could continue to 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 Federal Reserve, 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 Sterling can 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 Sterling s borrowers, potentially increasing the risk that they may fail to repay their loans. Changes in Federal Reserve policies are beyond Sterling s control and hard to predict or anticipate.

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

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.

**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. Sterling Savings Bank, as a Washington State-chartered commercial bank, and Golf Savings Bank, as a Washington State chartered savings bank, are each subject to regulation and supervision by the FDIC and the WDFI. 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 and the WDFI 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 in certain cases, obtain capital or financing.

**Changes in market interest rates could continue to 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. Sterling s primary source 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. Recently, in response to significant reductions in short term interest rates by the Federal Reserve, Sterling s net interest income has decreased.

While short term interest rates recently have been declining, the amount of interest Sterling pays on deposits have not declined as quickly as the amount of interest Sterling receives on its loans. This has caused Sterling s profits to decrease. Declines in interest rates also increase the volume of pre-payments on fixed rate loans and mortgage-related securities, generally at levels directly proportional to the loan or securities interest rate. Increases in pre-payments cause Sterling to lose interest income at a faster pace than anticipated when the loan was made or the securities purchased. Sterling s ability to reinvest these pre-payments will generally be limited to loans and securities yielding a lower rate of interest than on the original loans and securities.

Alternatively, in cycles in which interest rates are rising, the value of Sterling s mortgage-related securities and investment securities may decline, and the demand for loans may decrease. An increase in interest rates could reduce 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 credit losses. Increasing market interest rates may depress property values, which could affect the value of collateral securing Sterling loans. Additionally, 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 a change in one or more variables.**

Sterling s cost of funds may remain higher than prevailing interest rates because of general economic conditions, unfavorable conditions in the capital markets, interest rates, debt ratings 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. There can be no assurance additional borrowings, if sought, would be available to us or, if available, would be on favorable terms. If additional borrowing sources are unavailable or not available on reasonable terms, our financial condition, results of operations and future prospects could be materially adversely affected.

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**Competition and recent operating results may adversely affect Sterling s ability to attract and retain customers at current levels.**

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

In particular, Sterling s competitors include major financial companies whose greater resources may provide them a marketplace advantage. Areas of competition include interest rates for loans and deposits, efforts to obtain deposits and the range and quality of services provided. Because Sterling has fewer financial and other resources than larger institutions with which it competes, Sterling may be limited in its ability to attract customers. In addition, some of the current commercial banking customers may seek alternative banking sources as they develop needs for credit facilities larger than Sterling can accommodate. Sterling s recent operating results may also deter certain current or prospective deposit customers. 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 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. 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.

**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.

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In connection with Sterling s sale of preferred stock to the Treasury Department as part of its participation in the CPP, Sterling agreed to abide by certain limitations on the compensation that it is able to pay to certain of its executive officers. More stringent restrictions on executive compensation were imposed by Congress on CPP participants in February 2009 as part of the ARRA, and these restrictions apply retroactively. Congress may impose additional restrictions in the future that may also apply retroactively. These restrictions may have an adverse affect on Sterling s ability to attract and retain executive talent. 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.

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

Sterling has identified owner occupied 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 may carry greater risk of payment default than residential real estate loans. As the volume of these loans increases, credit risk may increase. In the event of substantial borrower defaults, Sterling s provision for credit losses would increase and therefore, earnings would be reduced.

**Our deposit insurance premiums are expected to increase substantially, which will adversely affect our operating results.**

Our deposit insurance expense for the year ended December 31, 2008 was $6.6 million, compared to $2.9 million for 2007. Deposit insurance premiums are expected to increase in 2009 due to recent strains on the FDIC deposit insurance fund resulting from the cost of large bank failures and an increase in the number of troubled banks. The current rates for the FDIC assessments have ranged from 5 to 43 basis points, depending on the health of the insurance institution. The FDIC has proposed increasing that assessment range to 12 to 50 basis points for the first quarter of 2009. Effective April 1, 2009, the FDIC has proposed an assessment rate range of 12 to 45 basis points for institutions that do not exceed a certain threshold amount of brokered deposits and secured liabilities, and higher rates for those that do exceed the threshold amount. The FDIC has also proposed that it could increase assessment rates in the future without formal rulemaking.

On February 27, 2009, the FDIC adopted an amended Restoration Plan for the DIF that was originally established and implemented on October 7, 2008. The amended Plan requires an increase in premium assessment rates to return the DIF reserve ratio to 1.15 percent within seven years. The FDIC also adopted an interim rule imposing a special assessment equal to 20 basis points of an institution s assessment base on June 30, 2009. The assessment will be payable on or about September 30, 2009. The interim rule provides that the FDIC may impose additional emergency special assessments of up to 10 basis points, if necessary. There can be no assurance as to what the amount of the assessment rates will be when the final rule is adopted.

**If all or a significant portion of the unrealized losses in Sterling s portfolio of investment securities were determined to be other-than-temporarily impaired, Sterling would recognize a material charge to its earnings and its capital ratios would be adversely impacted.**

As of December 31, 2008, there were $17.9 million of after-tax net unrealized losses associated with Sterling s portfolio of investment securities available for sale. Generally, the fair value of such securities is based upon market values supplied by third-party sources. When the fair value of a security declines, management must assess whether that decline is other-than-temporary. When management reviews whether a decline in fair value is other-than-temporary, it considers numerous factors, many of which involve significant judgment. For further discussions see Critical Accounting Policies. More generally, market conditions continue to be volatile, and no assurance can be provided that the amount of the unrealized losses will not increase or that the factors may change resulting in a determination that the losses are other-than-temporarily impaired. If impaired, Sterling would recognize a charge to its earnings in the quarter during which such determination is made and its capital ratios will be adversely impacted.

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**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 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 stock price has been volatile.**

Sterling s stock price has fluctuated widely, and may continue to do so, 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, 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. On December 5, 2008, in addition to the preferred shares that were issued to the Treasury Department, Sterling issued a ten year warrant to purchase 6,437,677 shares of Sterling common stock at an exercise price of $7.06 per share. There are 100,000,000 shares of Sterling common stock authorized, of which 52,134,030 shares were outstanding as of December 31, 2008.

**Regulatory and contractual restrictions may limit or prevent us from paying dividends on our common stock and preferred stock, or meeting other obligations.**

As a bank holding company, Sterling s ability to declare and pay dividends is dependent on certain regulatory and contractual considerations. Sterling is an entity separate and distinct from its principal subsidiaries, Sterling Savings Bank and Golf Savings Bank, and derives substantially all of its revenue in the form of dividends from those subsidiaries. Accordingly, Sterling is and will be dependent upon dividends from Sterling Savings Bank and Golf Savings Bank to pay the principal of and interest on its indebtedness, to pay dividends on its common stock and on the preferred stock issued by Sterling to the Treasury Department, and to satisfy other obligations and cash needs of the holding company. Sterling Savings Bank and Golf Savings Bank s ability to pay dividends is subject to their ability to earn net income and to meet certain regulatory requirements. In the event Sterling s subsidiary banks are unable to pay dividends to Sterling, it may not be able to service its debt, pay its obligations or pay dividends on its common stock or preferred stock.

Pursuant to the terms of the purchase agreement entered into by Sterling with the Treasury Department in connection with Sterling s sale of Sterling s preferred stock as part of its participation in the CPP, Sterling s ability to declare or pay dividends or distributions on, or purchase, redeem or otherwise acquire for consideration, shares of its common stock is limited and includes a restriction against increasing dividends from Sterling s prior quarterly cash dividend of $0.10 per share. The ability of Sterling to declare or pay dividends or distributions on, or repurchase, redeem or otherwise acquire for consideration, shares of its common stock is also subject to restrictions in the event that Sterling fails to declare and pay full dividends (or declare and set aside a sum sufficient for payment thereof) on its preferred stock. Furthermore, Sterling may only pay dividends: (1) if there are lawfully available funds, as provided under Washington law; and (2) when, as and if authorized and declared by Sterling s board of directors, which depends on, among other things, the results of operations, financial condition, debt service requirements, other cash needs and any other factors the board of directors deems relevant.

**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

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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, 2008, Sterling also owned 101 of its 179 depository 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 38 non-depository loan production offices throughout the western United States, the majority of which are leased. See Note 6 of Notes to 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.

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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 s common stock is listed on The NASDAQ Global Select Market under the symbol STSA. As of January 31, 2009, Sterling s common stock was held by 52,394,260 shareholders of record. The following table sets forth certain per share information for Sterling s common stock for the periods indicated:

| | 2008 Quarters Ended | | | |
|---|---|---|---|---|
| | December 31 | September 30 | June 30 | March 31 |
| Dividends declared per common share | $ 0.000 | $ 0.100 | $ 0.100 | $ 0.100 |
| Dividends paid per common share | 0.100 | 0.100 | 0.100 | 0.095 |
| Market price per share: | | | | |
| High | 15.00 | 17.50 | 16.59 | 19.72 |
| Low | 3.50 | 2.36 | 4.02 | 12.21 |
| Quarter end | 8.80 | 14.50 | 4.14 | 15.61 |

| | 2007 Quarters Ended | | | |
|---|---|---|---|---|
| | December 31 | September 30 | June 30 | March 31 |
| Dividends declared per common share | $ 0.095 | $ 0.090 | $ 0.085 | $ 0.080 |
| Dividends paid per common share | 0.090 | 0.085 | 0.080 | 0.075 |
| Market price per share: | | | | |
| High | 28.73 | 29.28 | 31.40 | 34.64 |
| Low | 16.30 | 20.10 | 28.20 | 30.11 |
| Quarter end | 16.79 | 26.91 | 28.94 | 31.19 |

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. Pursuant to the terms of Sterling s participation in the CPP program of the Treasury Department, Sterling is prohibited from increasing the dividends to be paid to shareholders above the $0.10 per share quarterly dividend paid for the quarter ended September 30, 2008. This restriction on Sterling s ability to pay dividends will continue until either Sterling redeems all of the preferred shares sold to the Treasury Department, or December 2011, whichever is earliest. In January 2009, Sterling suspended payment of its quarterly cash dividends on its common shares until economic conditions improve.

**Recent Sales of Unregistered Securities**

On December 5, 2008, Sterling entered into an agreement (the Purchase Agreement ), with the United States Department of the Treasury ( Treasury Department ), pursuant to which Sterling issued and sold to the Treasury Department (i) 303,000 shares of Sterling s Fixed Rate Cumulative Perpetual Preferred Stock, Series A, (the Preferred Stock ) and (ii) a warrant (the Warrant ) to purchase 6,437,677 shares of Sterling s common stock, for an aggregate purchase price of $303 million. The description of the Purchase Agreement contained herein is a summary and is qualified in its entirety by reference to the full text of the Purchase Agreement attached as Exhibit 10.1 to Sterling s current report on Form 8-K filed with the SEC on December 5, 2008, which is incorporated herein by reference.

The Warrant has a 10-year term and is immediately exercisable upon its issuance, with an initial per share exercise price of $7.06. The Warrant provides for the adjustment of the exercise price and the number of shares of common stock issuable upon exercise pursuant to customary anti-dilution provisions, such as upon stock splits

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or distributions of securities or other assets to holders of common stock, and upon certain issuances of common stock at or below a specified price relative to the initial exercise price. If Sterling receives aggregate gross cash proceeds of not less than $303 million from Qualified Equity Offerings, as that term is defined in the Purchase Agreement, on or prior to December 31, 2009, the number of shares of common stock issuable pursuant to Treasury Department s exercise of the Warrant will be reduced by one half of the original number of shares, taking into account all adjustments, underlying the Warrant. Pursuant to the Purchase Agreement, Treasury has agreed not to exercise voting power with respect to any shares of common stock issued upon exercise of the Warrant. During the term of the Warrant, if at any time the shares of common stock of Sterling are no longer listed or admitted to trading on a national securities exchange (other than in connection with certain business combinations), the Treasury may cause Sterling to exchange all or a portion of the Warrant for another economic interest of Sterling (determined by the Treasury in consultation with Sterling) classified as permanent equity under U.S. GAAP with an equivalent fair market value. The description of the Warrant contained herein is a summary and is qualified in its entirety by reference to the full text of the Warrant Certificate, which is attached as Exhibit 4.2 to Sterling s current report on Form 8-K filed with the SEC on December 5, 2008, which is incorporated herein by reference.

The Preferred Stock and the Warrant were issued in a private placement exempt from registration pursuant to Section 4(2) of the Securities Act of 1933, as amended (the Securities Act ). Sterling filed a registration statement on Form S-3, with the SEC on January 6, 2009 to register the Preferred Stock, the Warrants and the common stock to be issued pursuant to the terms of the Warrant.

**Performance Graph**

The following graph compares our cumulative total stockholder return since December 31, 2003 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, 2003.

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**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, | | | | |
|---|---|---|---|---|---|
| | 2008 | 2007 | 2006 | 2005 | 2004 |
| | (Dollars in thousands, except per share amounts) | | | | |
| Income Statement Data: | | | | | |
| Interest income | $ 715,062 | $ 766,978 | $ 550,855 | $ 387,811 | $ 319,761 |
| Interest expense | (355,510) | (411,618) | (286,943) | (171,276) | (122,945) |
| Net interest income | 359,552 | 355,360 | 263,912 | 216,535 | 196,816 |
| Provision for credit losses | (333,597) | (25,088) | (18,703) | (15,200) | (12,150) |
| Net interest income after provision for credit losses | 25,955 | 330,272 | 245,209 | 201,335 | 184,666 |
| Non-interest income | 72,108 | 93,478 | 69,340 | 59,569 | 47,799 |
| Non-interest expenses | (285,730) | (285,537) | (206,373) | (170,281) | (148,370) |
| Goodwill impairment | (223,765) | 0 | 0 | 0 | 0 |
| Total non-interest expenses | (509,495) | (285,537) | (206,373) | (170,281) | (148,370) |
| Income before income taxes | (411,432) | 138,213 | 108,176 | 90,623 | 84,095 |
| Income tax benefit (provision) | 75,898 | (44,924) | (34,230) | (29,404) | (27,790) |
| Net income (loss) | (335,534) | 93,289 | 73,946 | 61,219 | 56,305 |
| Preferred stock dividend | (1,208) | 0 | 0 | 0 | 0 |
| Net income (loss) applicable to common shareholders | $ (336,742) | $ 93,289 | $ 73,946 | $ 61,219 | $ 56,305 |
| Earnings per common share: | | | | | |
| Basic[(1)] | $ (6.51) | $ 1.87 | $ 2.03 | $ 1.77 | $ 1.66 |
| Diluted[(1)] | (6.51) | 1.86 | 2.01 | 1.75 | 1.62 |
| Dividends declared per common share | $ 0.300 | $ 0.350 | $ 0.270 | $ 0.105 | $ 0.000 |
| Weighted average shares outstanding: | | | | | |
| Basic[(1)] | 51,721,671 | 49,786,349 | 36,423,095 | 34,633,952 | 33,931,509 |
| Diluted[(1)] | 51,721,671 | 50,217,515 | 36,841,866 | 35,035,029 | 34,708,794 |
| Other Data: | | | | | |
| Book value per common share[(1)] | $ 16.29 | $ 23.04 | $ 18.63 | $ 14.54 | $ 13.65 |
| Tangible book value per common share[(1)] | $ 11.41 | $ 13.61 | $ 12.07 | $ 10.80 | $ 9.81 |
| Return on assets | -2.65% | 0.83% | 0.88% | 0.87% | 0.88% |
| Return on common equity | -28.8% | 8.6% | 13.0% | 12.4% | 13.2% |
| Shareholders equity to total assets | 8.9% | 9.8% | 8.0% | 6.7% | 6.8% |
| Operating efficiency | 118.0% | 63.6% | 61.9% | 61.7% | 60.7% |
| Tax equivalent net interest margin | 3.08% | 3.42% | 3.33% | 3.30% | 3.34% |
| Nonperforming assets to total assets | 4.77% | 1.04% | 0.11% | 0.11% | 0.20% |
| Employees (full-time equivalents) | 2,481 | 2,571 | 2,405 | 1,789 | 1,624 |
| Depository branches | 179 | 178 | 166 | 140 | 135 |

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**Item 6. Selected Financial Data (continued)**

| | 2008 | 2007 | December 31, 2006 (Dollars in thousands) | 2005 | 2004 |
|---|---|---|---|---|---|
| Balance Sheet Data: | | | | | |
| Total assets | $ 12,790,716 | $ 12,149,775 | $ 9,834,492 | $ 7,562,377 | $ 6,944,234 |
| Loans receivable, net | 8,807,094 | 8,948,307 | 7,021,241 | 4,889,366 | 4,253,887 |
| Mortgage-backed securities | 2,639,290 | 1,785,031 | 1,687,672 | 1,960,582 | 2,036,920 |
| Investments | 175,830 | 201,033 | 134,077 | 91,331 | 92,819 |
| Deposits | 8,350,407 | 7,677,772 | 6,746,028 | 4,806,301 | 3,863,296 |
| FHLB advances | 1,726,549 | 1,687,989 | 1,308,617 | 1,443,462 | 1,635,933 |
| Reverse repurchase agreements and funds purchased | 1,163,023 | 1,178,845 | 616,354 | 611,676 | 780,012 |
| Other borrowings | 248,276 | 273,015 | 240,226 | 110,688 | 131,822 |
| Shareholders equity | 1,141,036 | 1,185,330 | 783,416 | 506,685 | 469,844 |
| Capital Ratios(2): | | | | | |
| Tier 1 leverage (to average assets) | | | | | |
| Sterling | 9.2% | 8.7% | 8.7% | 7.4% | N/A |
| Sterling Savings Bank | 8.3% | 8.5% | 8.6% | 7.2% | 6.6% |
| Golf Savings Bank | 12.6% | 7.3% | 6.9% | N/A | N/A |
| Tier I (to risk-weighted assets) | | | | | |
| Sterling | 11.7% | 10.1% | 10.0% | 9.5% | N/A |
| Sterling Savings Bank | 10.6% | 9.8% | 9.7% | 9.2% | 9.7% |
| Golf Savings Bank | 17.8% | 10.2% | 10.9% | N/A | N/A |
| Total (to risk-weighted assets) | | | | | |
| Sterling | 13.0% | 11.3% | 11.1% | 10.5% | N/A |
| Sterling Savings Bank | 11.8% | 11.0% | 10.8% | 10.2% | 10.7% |
| Golf Savings Bank | 19.1% | 10.8% | 11.6% | 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.

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**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 and Risk Factors.*

**Executive Summary and Highlights**

Sterling s earnings per share and performance ratios for 2008 were impacted by the major disruption in the housing market and downturn in the economy, which has resulted in Sterling recording a credit provision that was higher than the provision recorded during 2007, and recorded a $223.8 million non-cash charge to reflect impairment of Sterling s goodwill as a result of a number of factors, including the sustained and protracted decline in Sterling s stock price and market capitalization. During 2008, Sterling recorded a $333.6 million provision for credit losses compared with $25.1 million for 2007. Sterling increased the credit provision in response to worsening economic conditions, the continued stress on real estate values, increasing levels of both classified and non-performing assets, as well as higher net charge-offs and the requirement for additional allowances for loan loss caused by a change in determining the fair market value of impaired loans. As of December 31, 2008, non-performing assets were $610.7 million versus $135.2 million at December 31, 2007.

During 2008 Sterling took a number of steps to enhance and preserve its capital base and protect customer deposits. During the first quarter of 2008, Sterling activated a Residential Construction Special Project Team to identify, manage and resolve credit quality issues. During the third quarter of 2008, Sterling separated its credit administration team into two dedicated teams: one to fix, repair and manage construction assets; and, the other to focus on generating strategic business and consumer assets. During the fourth quarter of 2008, Sterling strengthened its capital position by raising $303 million through the sale of preferred shares and a related warrant to the U.S. Department of the Treasury (the Treasury Department ) as part of the Treasury Department s Capital Purchase Program. In January 2009, Sterling suspended payment of its quarterly cash dividends on its common shares until economic conditions improve.

Sterling s retail and commercial banking groups continued to perform well, generating net interest income before the provision for credit losses of $359.6 million for 2008 versus $355.4 million for 2007. Sterling remains well capitalized, with excess liquidity, and expects to continue lending to the communities it serves, as well as to continue to absorb elevated credit costs.

**2008 HIGHLIGHTS**

Capital ratios remain above well-capitalized levels at 13.0%.

Available liquidity remains strong at $3.2 billion.

Tangible book value per common share was $11.41.

Tangible shareholders equity-to-tangible asset ratio improved to 7.07% from 6.01%.

Total assets were $12.79 billion.

Total loans receivable were $8.81 billion.

Total deposits increased 9% to a record $8.35 billion.

**Critical Accounting Policies**

The accounting and reporting policies of Sterling conform to generally accepted accounting principles ( 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 when 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 non-performing loans is included in income only if principal recovery is reasonably assured. A non-performing 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 Credit Losses.*** The allowance for credit losses is composed of the allowance for loan losses and the reserve for unfunded credit commitments. In general, determining the amount of the allowance requires significant judgment and the use of estimates by management. Sterling maintains an allowance for credit 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 and confirmed losses, levels and trends in classified and non-performing 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.

During the fourth quarter of 2008, Sterling modified its estimate of the fair value of loans being tested for impairment. The fair value is now estimated excluding the potential cash flows from certain guarantors. To the extent that these guarantors are able to provide repayments, a recovery would be recorded upon receipt. In addition, Sterling re-assessed the accounting for real estate loans treated as collateral dependent. As a result, Sterling now considers any impairment on a collateral-dependent loan to be a confirmed loss and charges off the impairment amount when the impairment is identified, rather than establishing a specific allowance on impaired collateral-dependent loans that would have been charged off when foreclosure was probable.

Individual loan reviews are based upon specific quantitative and qualitative criteria, including the size of the loan, loan quality ratings, value of collateral, repayment ability of borrowers, and historical experience factors. The historical experience factors used and allowances for homogeneous loans (such as residential mortgage loans, consumer loans, etc.) are collectively evaluated based upon historical loss experience, trends in losses and delinquencies, growth of loans in particular markets, and known changes in economic conditions in each particular lending market.

While management uses available information to provide for loan losses, the ultimate collectability 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. The slowdown in economic activity could continue to adversely affect cash flows for both commercial and individual borrowers, as a result of which Sterling could experience further increases in non-performing assets, delinquencies and losses on loans. There can be no assurance that the allowance for credit losses will be adequate to cover all losses, but management believes the allowance for credit losses was adequate at December 31, 2008.

***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 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. Sterling s MBS are primarily in agency securities, with limited investments in non-agency obligations. Municipal bonds that Sterling holds are all general obligation in nature, spread throughout Sterling s footprint. Sterling does not invest in collateralized debt obligations or similar exotic structured investment products.

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 that management identified to be other-than-temporarily impaired for the year ended December 31, 2008, because the decline in fair value of certain classes of securities was attributable to temporary disruptions of credit markets and the impact on securities within those classes, not deteriorating credit quality of specific securities. Sterling holds positions in classes of securities negatively impacted by temporary credit market disruptions, including one single issuer trust preferred, and 19 private label collateralized mortgage obligations. The trust preferred is rated A1 by Moody s and has an amortized cost of $24.6 million compared to a $12.9 million market value, or an unrealized loss of $11.7 million. The private label collateralized mortgage obligations are all rated AAA, except for $10.1 million of such securities that are rated Aa3 by Moody s and have an amortized cost of $275.9 million compared to a $227.5 million market value, or an unrealized loss of $48.4 million. All of the aforementioned positions remain high quality investment grade, and all are quarterly stress-tested for both credit quality and collateral strength. As of December 31, 2008, Sterling expects the return of all principal and interest on all securities within the portfolios pursuant to the contractual terms and therefore Sterling is positioned to maintain 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 recovery, a change in management s assessment of credit risk, or a change in regulatory or accounting requirements. See Note 2 of Notes to Consolidated Financial Statements.

***Fair Value of Financial Instruments.*** Sterling s available-for-sale securities portfolio totaled $2.64 billion and $1.85 billion as of December 31, 2008 and 2007, respectively, and were the majority of Sterling s financial instruments that are carried at fair value. These securities are valued using a pricing service s matrix technique based on quoted prices for similar instruments, which Sterling validates with non-binding broker quotes, in depth collateral analysis and cash flow stress testing.

Loans held for sale are also carried at fair value, as Sterling has applied FAS 159 to these loans in order to match changes in the value of the loans with the value of the economic hedges on the loans without having to apply complex hedge accounting. The fair value of loans held for sale is determined based upon an analysis of investor quoted pricing inputs.

***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.

Sterling s management performed an annual test of its goodwill and other intangible assets as of June 30, 2008, and concluded that the recorded values were not impaired, based on present value discounted cash flow analysis as allowed by FAS 142. During the fourth quarter of 2008, due to reduced expectations for near term profitability, and the protracted decline in Sterling s stock price and market capitalization, Sterling determined that an impairment had occurred, and wrote off $223.8 million of its goodwill. Further deterioration in its loan portfolio from worsening economic conditions, continued stress on real estate values, increasing levels of both classified and non-performing assets and higher net charge-offs, resulted in higher credit costs. Dividends on Sterling s newly issued preferred stock reduce income that is available to common shareholders. Sterling will continue to perform an annual test on the remainder of its goodwill, and evaluate on a quarterly basis the need to perform an interim test. There are many assumptions and estimates underlying the determination of whether goodwill has been impaired. Future events could cause management to conclude that Sterling s goodwill or other intangible assets have become further impaired, which would result in Sterling recording an additional impairment loss. Other intangible assets consisting of core deposit intangibles with definite lives are amortized on a straight line basis over the estimated life of the acquired depositor relationships (generally eight to ten years).

***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

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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**

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. 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. Net interest spread refers to the difference between the yield on interest-earning assets and the rate paid on interest-bearing liabilities.

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The following table sets forth, on a tax equivalent basis, information with regard to Sterling s NII, net interest spread and net interest margin:

| | Years Ended December 31, | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2008 | | | 2007 | | | 2006 | | |
| | Average Balance | Income/ Expense | Average Yield/ Rate(1) | Average Balance | Income/ Expense | Average Yield/ Rate(1) | Average Balance | Income/ Expense | Average Yield/ Rate(1) |
| | (Dollars in thousands) | | | | | | | | |
| **ASSETS:** | | | | | | | | | |
| Loans: | | | | | | | | | |
| Mortgage | $ 5,501,102 | $ 350,718 | 6.38% | $ 4,994,656 | $ 401,084 | 8.03% | $ 3,291,944 | $ 257,811 | 7.83% |
| Commercial and consumer | 3,850,263 | 249,020 | 6.47% | 3,568,815 | 279,422 | 7.83% | 2,599,651 | 201,133 | 7.74% |
| Total loans | 9,351,365 | 599,738 | 6.41% | 8,563,471 | 680,506 | 7.95% | 5,891,595 | 458,944 | 7.79% |
| Mortgage-backed securities | 2,051,882 | 102,863 | 5.01% | 1,655,371 | 79,266 | 4.79% | 1,862,144 | 88,398 | 4.75% |
| Investments and cash equivalents | 423,368 | 16,660 | 3.94% | 270,384 | 10,302 | 3.81% | 233,611 | 5,500 | 2.35% |
| Total interest-earning assets | 11,826,615 | 719,261 | 6.08% | 10,489,226 | 770,074 | 7.34% | 7,987,350 | 552,842 | 6.92% |
| Noninterest-earning assets | 841,147 | | | 778,201 | | | 411,213 | | |
| Total average assets | $ 12,667,762 | | | $ 11,267,427 | | | $ 8,398,563 | | |
| **LIABILITIES and EQUITY:** | | | | | | | | | |
| Deposits: | | | | | | | | | |
| Transaction | $ 1,321,932 | 1,372 | 0.10% | $ 1,359,066 | 2,543 | 0.19% | $ 1,106,321 | 1,692 | 0.15% |
| Savings and MMDA | 2,173,133 | 46,231 | 2.13% | 2,078,984 | 71,665 | 3.45% | 1,512,198 | 47,844 | 3.16% |
| Time deposits | 4,553,160 | 186,734 | 4.10% | 4,039,152 | 203,406 | 5.04% | 2,962,017 | 135,737 | 4.58% |
| Total deposits | 8,048,225 | 234,337 | 2.91% | 7,477,202 | 277,614 | 3.71% | 5,580,536 | 185,273 | 3.32% |
| Borrowings | 3,292,287 | 121,173 | 3.68% | 2,604,764 | 134,004 | 5.14% | 2,125,620 | 101,670 | 4.78% |
| Total interest-bearing liabilities | 11,340,512 | 355,510 | 3.13% | 10,081,966 | 411,618 | 4.08% | 7,706,156 | 286,943 | 3.72% |
| Noninterest-bearing liabilities | 136,082 | | | 101,044 | | | 122,435 | | |
| Total average liabilities | 11,476,594 | | | 10,183,010 | | | 7,828,591 | | |
| Total average shareholders equity | 1,191,168 | | | 1,084,417 | | | 569,972 | | |
| Total average liabilities and equity | $ 12,667,762 | | | $ 11,267,427 | | | $ 8,398,563 | | |
| Tax equivalent net interest spread | | $ 363,751 | 2.95% | | $ 358,456 | 3.26% | | $ 265,899 | 3.20% |
| Tax equivalent net interest margin | | | 3.08% | | | 3.42% | | | 3.33% |
| Ratio of average interest-earning assets to average interest-bearing liabilities | | | 104.29% | | | 104.04% | | | 103.65% |

(1) 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.

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

Volume changes in volume multiplied by comparative period rate;

Rate changes in rate multiplied by comparative period volume; and

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

| | December 31, 2008 Increase (Decrease) Due to: | | | | December 31, 2007 Increase (Decrease) Due to: | | | |
|---|---|---|---|---|---|---|---|---|
| | Volume | Rate | Rate/ Volume | Total | Volume | Rate | Rate/ Volume | Total |
| | (Dollars in thousands) | | | | | | | |
| Interest income: | | | | | | | | |
| Loans: | | | | | | | | |
| Mortgage | $ 40,669 | $ (82,654) | $ (8,381) | $ (50,366) | $ 133,349 | $ 6,541 | $ 3,383 | $ 143,273 |
| Commercial and consumer | 22,036 | (48,605) | (3,833) | (30,402) | 74,984 | 2,408 | 897 | 78,289 |
| Total loans | 62,705 | (131,259) | (12,214) | (80,768) | 208,333 | 8,949 | 4,280 | 221,562 |
| Mortgage-backed securities | 18,986 | 3,720 | 892 | 23,598 | (9,816) | 769 | (85) | (9,132) |
| Investment and cash equivalents | 5,828 | 339 | 192 | 6,359 | 866 | 3,401 | 535 | 4,802 |
| Total interest income | 87,519 | (127,200) | (11,130) | (50,811) | 199,383 | 13,119 | 4,730 | 217,232 |
| Interest expense: | | | | | | | | |
| Deposits | 29,061 | (66,320) | (6,016) | (43,275) | 67,680 | 18,087 | 6,574 | 92,341 |
| Borrowings | 35,370 | (38,135) | (10,066) | (12,831) | 22,918 | 7,684 | 1,732 | 32,334 |
| Total interest expense | 64,431 | (104,455) | (16,082) | (56,106) | 90,598 | 25,771 | 8,306 | 124,675 |
| Changes in net interest income on a tax equivalent basis | $ 23,088 | $ (22,745) | $ 4,952 | $ 5,295 | $ 108,785 | $ (12,652) | $ (3,576) | $ 92,557 |

**2008 versus 2007**

***Net Interest Income.*** During the years ended December 31, 2008 and 2007, NII was $359.6 million and $355.4 million, respectively, with the 1% increase attributable to growth in average loan balances. The growth rate in loans slowed during 2008, and turned negative in the second half of the year, reflecting a lower level of originations and an increased provision for loan losses in response to the general economic decline and specific loan portfolio deterioration.

During the years ended December 31, 2008 and 2007, net interest margin was 3.08% and 3.42%, respectively. Net interest income and net interest margin have been negatively affected by the increase in non-performing assets, and the decline in the prime rate. Sterling has been asset sensitive during recent periods, with a higher level of interest earning assets that were subject to re-pricing faster in the short term than deposits and borrowings. Additionally, when loans reach non-performing status, the reversal and cessation of accruing interest has an immediate negative impact on net interest margin. Reversal of $28.6 million in accrued interest income on non-performing loans lowered net interest margin by 24 basis points compared with a decline of 4 basis points, or $4.3 million, for 2007.

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***Provision for Credit Losses.*** 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 credit losses of $333.6 million and $25.1 million for the years ended December 31, 2008 and 2007, respectively. Sterling has increased its provision for credit losses in response to an increase in the level of classified loans, particularly in the residential construction portfolio, and an assessment of the other relevant factors mentioned in the preceding paragraph. During the fourth quarter of 2008, the appraisal values of real estate reflected significant declines, and Sterling modified its methods of estimating the fair value of impaired loans.

The following table summarizes the allowance for credit losses activity for the periods indicated:

| | Years Ended December 31, | |
|---|---|---|
| | 2008 | 2007 |
| | (Dollars in thousands) | |
| Allowance loans, January 1 | $ 111,026 | $ 77,849 |
| Acquired | 0 | 15,294 |
| Provision | 333,597 | 24,838 |
| Charge-offs | (223,324) | (7,682) |
| Recoveries | 2,078 | 933 |
| Transfers | (15,012) | (206) |
| Allowance loans, December 31 | 208,365 | 111,026 |
| Allowance unfunded commitments, January 1 | 6,306 | 5,840 |
| Acquired | 0 | 0 |
| Provision | 62 | 260 |
| Charge-offs | (46) | 0 |
| Transfers | 15,012 | 206 |
| Allowance unfunded commitments, December 31 | 21,334 | 6,306 |
| Total credit allowance | $ 229,699 | $ 117,332 |
| Loan loss allowance to total loans | 2.31% | 1.23% |
| Total credit allowance to total loans | 2.55% | 1.30% |

Sterling modified its methodology for estimating the fair value of loans being tested for impairment during the fourth quarter of 2008. The fair value is now determined excluding the potential cash flows from certain guarantors. To the extent that these guarantors are able to provide repayments, a recovery would be recorded upon receipt. In addition to the higher credit provision recorded during the fourth quarter of 2008, in many cases, Sterling re-assessed the accounting for real estate loans treated as collateral dependent. As a result, Sterling now considers any impairment on a collateral-dependent loan to be a confirmed loss and charges off the impairment amount when the impairment is identified, rather than establishing a specific allowance on impaired collateral-dependent loans that would have been charged off when foreclosure was probable. As a result of this change, the specific loss allowance was reduced by approximately $163.9 million and is now reflected as part of net charge-offs.

During 2007, Sterling acquired an allowance for losses on loans as a result of the Northern Empire acquisition. These acquired loans were determined to not have exhibited a deterioration in credit quality since origination,

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and thus were not included within the scope of the American Institute of Certified Public Accountants Statement of Position 03-3, Accounting for Certain Loans or Debt Securities Acquired in a Transfer.

Non-performing assets, a subset of classified assets that includes non-performing loans and real estate owned, were 4.77% of total assets at December 31, 2008, compared with 1.11% of total assets at December 31, 2007. At December 31, 2008, the delinquency ratio for loans 60 days or more past due was 4.86% of total loans compared to 1.23% of total loans at December 31, 2007. Recently, Sterling, like many other financial institutions, has experienced deterioration in the credit quality of residential construction loans and increases in delinquencies due to declining market values and weakness in housing sales in certain of its markets.

At December 31, 2008, Sterling s total classified assets were 7.70% of total assets, compared with 1.93% of total assets at December 31, 2007. The following table describes classified assets by asset type as of the dates indicated:

| | December 31, 2008 | September 30, 2008 | June 30, 2008 | March 30, 2008 | December 31, 2007 |
|---|---|---|---|---|---|
| | | | (Dollars in thousands) | | |
| Residential real estate | $ 34,333 | $ 36,863 | $ 21,848 | $ 5,021 | $ 711 |
| Multifamily real estate | 16,741 | 7,313 | 2,289 | 470 | 248 |
| Commercial real estate | 37,890 | 14,931 | 6,390 | 6,277 | 3,224 |
| Construction | | | | | |
| Residential construction | 548,384 | 405,753 | 309,556 | 255,473 | 117,424 |
| Multifamily and commercial construction | 119,348 | 17,109 | 19,042 | 15,182 | 3,566 |
| Total construction | 667,732 | 422,862 | 328,598 | 270,655 | 120,990 |
| Consumer direct and indirect | 4,556 | 4,489 | 3,994 | 2,949 | 2,627 |
| Commercial banking | 143,748 | 130,250 | 111,344 | 104,394 | 95,461 |
| Total classified loans | 905,000 | 616,708 | 474,463 | 389,766 | 223,261 |
| REO | 79,875 | 54,795 | 22,998 | 13,027 | 11,075 |
| Total classified assets | $ 984,875 | $ 671,503 | $ 497,461 | $ 402,793 | $ 234,336 |

At December 31, 2008, 74% of classified assets are related to construction, the majority of which was residential construction. The commercial construction and commercial banking loan portfolio have also been affected by the downturn in the housing market. The following table summarizes the principal balances of non-performing assets at the dates indicated:

| | December 31, 2008 | December 31, 2007 |
|---|---|---|
| | (Dollars in thousands) | |
| Past due 90 days | $ 0 | $ 0 |
| Nonaccrual loans | 474,172 | 123,790 |
| Restructured loans | 56,618 | 350 |
| Total nonperforming loans | 530,790 | 124,140 |
| Real estate owned | 79,875 | 11,075 |
| Total nonperforming assets | 610,665 | 135,215 |
| Specific reserves | (19,535) | (8,678) |
| Net nonperforming assets | $ 591,130 | $ 126,537 |

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Past due 90 days represents loans that are 90 days or more delinquent in regards to interest or principal, and that Sterling is still accruing interest on. The allowance for losses on REO is included in the specific reserve, and totaled $17.6 million at December 31, 2008. The following table describes non-performing assets by asset type at the dates indicated. The following table describes non-performing assets by asset type at the dates indicated:

| | December 31, 2008 | December 31, 2007 |
|---|---|---|
| | (Dollars in thousands) | |
| Residential real estate | $ 46,043 | $ 1,557 |
| Multifamily real estate | 4,757 | 2,268 |
| Commercial real estate | 7,753 | 1,418 |
| Construction: | | |
| Residential | 410,338 | 102,373 |
| Multifamily | 3,894 | 0 |
| Commercial | 70,607 | 3,042 |
| Total construction | 484,839 | 105,415 |
| Consumer direct | 5,053 | 1,716 |
| Consumer indirect | 700 | 836 |
| Commercial banking | 61,520 | 22,005 |
| Total nonperforming assets | $ 610,665 | $ 135,215 |

Non-performing assets presented above are gross of their applicable specific loan loss reserve. The following presents residential construction non-performing assets by geographical market over the past several periods:

| | December 31, 2008 | September 30, 2008 | June 30, 2008 | March 31, 2008 | December 31, 2007 |
|---|---|---|---|---|---|
| | | | (Dollars in thousands) | | |
| Residential construction | | | | | |
| Portland, OR | $ 117,350 | $ 92,599 | $ 46,101 | $ 7,567 | $ 501 |
| Boise, ID | 23,356 | 41,046 | 34,939 | 37,338 | 32,728 |
| Utah | 29,586 | 38,143 | 36,179 | 15,372 | 3,603 |
| Puget Sound | 73,878 | 38,128 | 30,986 | 23,356 | 12,442 |
| Southern California | 67,824 | 32,322 | 40,085 | 28,032 | 23,614 |
| Bend, OR | 22,136 | 22,793 | 19,695 | 20,927 | 18,500 |
| Vancouver, WA | 14,486 | 19,704 | 19,854 | 19,943 | 2,103 |
| Other | 61,722 | 32,047 | 13,061 | 15,985 | 7,309 |
| Total residential construction | 410,338 | 316,782 | 240,900 | 168,520 | 100,800 |
| Commercial and multifamily construction | 74,501 | 21,609 | 12,270 | 9,756 | 3,042 |
| Other loan categories | 125,826 | 98,318 | 50,230 | 44,808 | 31,373 |
| Total gross nonperforming assets | 610,665 | 436,709 | 303,400 | 223,084 | |