

STERLING FINANCIAL CORP /WA/

Form 10-Q

May 09, 2006

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

**(Mark One)**

☒ **QUARTERLY REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934  
FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2006  
OR**

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

Washington  
(State or other jurisdiction of  
incorporation or organization)

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

111 North Wall Street, Spokane, Washington 99201  
(Address of principal executive offices) (Zip Code)  
(509) 458-3711

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Sections 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes ☐ No ☒

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

Large accelerated filer ☐ Accelerated filer ☐ Non-accelerated filer ☒

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

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

Class  
Common Stock (\$1.00 par value)

Outstanding as of April 27, 2006  
35,068,153

**STERLING FINANCIAL CORPORATION**  
**FORM 10-Q**  
**For the Quarter Ended March 31, 2006**  
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**PART I Financial Information**  
**Item 1 Financial Statements**  
**STERLING FINANCIAL CORPORATION**  
**Consolidated Balance Sheets**  
**(Unaudited)**

|                                                                                                | March 31,<br>2006      | December 31,<br>2005 |
|------------------------------------------------------------------------------------------------|------------------------|----------------------|
|                                                                                                | (Dollars in thousands) |                      |
| <b>ASSETS:</b>                                                                                 |                        |                      |
| Cash and cash equivalents:                                                                     |                        |                      |
| Interest bearing                                                                               | \$ 0                   | \$ 9,400             |
| Non-interest bearing and vault                                                                 | 116,755                | 121,907              |
| Restricted cash                                                                                | 967                    | 862                  |
| Investment securities and mortgage-backed securities ( MBS ):                                  |                        |                      |
| Available for sale                                                                             | 1,983,252              | 2,076,615            |
| Held to maturity                                                                               | 63,491                 | 51,924               |
| Loans receivable, net                                                                          | 5,249,515              | 4,885,916            |
| Loans held for sale                                                                            | 9,315                  | 7,894                |
| Accrued interest receivable                                                                    | 36,962                 | 35,805               |
| Real estate owned and other collateralized assets, net                                         | 5,160                  | 779                  |
| Office properties and equipment, net                                                           | 83,748                 | 82,432               |
| Bank-owned life insurance ( BOLI )                                                             | 108,816                | 107,649              |
| Goodwill                                                                                       | 112,702                | 112,707              |
| Other intangible assets                                                                        | 17,070                 | 17,625               |
| Mortgage servicing rights, net                                                                 | 5,137                  | 5,430                |
| Prepaid expenses and other assets, net                                                         | 47,395                 | 41,983               |
| <br>Total assets                                                                               | <br>\$ 7,840,285       | <br>\$ 7,558,928     |
| <br><b>LIABILITIES:</b>                                                                        |                        |                      |
| Deposits                                                                                       | \$ 5,085,302           | \$ 4,806,301         |
| Advances from Federal Home Loan Bank Seattle ( FHLB Seattle )                                  | 1,371,152              | 1,443,462            |
| Securities sold subject to repurchase agreements and funds purchased                           | 660,420                | 611,676              |
| Other borrowings                                                                               | 129,166                | 110,688              |
| Cashiers checks issued and payable                                                             | 6,699                  | 5,483                |
| Borrowers reserves for taxes and insurance                                                     | 2,442                  | 1,527                |
| Accrued interest payable                                                                       | 23,536                 | 18,169               |
| Accrued expenses and other liabilities                                                         | 52,848                 | 54,937               |
| <br>Total liabilities                                                                          | <br>7,331,565          | <br>7,052,243        |
| <br>Commitments and Contingencies                                                              |                        |                      |
| <b>SHAREHOLDERS EQUITY:</b>                                                                    |                        |                      |
| Preferred stock, \$1 par value; 10,000,000 shares authorized; no shares issued and outstanding | 0                      | 0                    |
|                                                                                                | 35,067                 | 34,856               |

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|                                                                                                                              |              |              |
|------------------------------------------------------------------------------------------------------------------------------|--------------|--------------|
| Common stock, \$1 par value; 60,000,000 shares authorized; 35,066,735 and 34,855,549 shares issued and outstanding           |              |              |
| Additional paid-in capital                                                                                                   | 388,800      | 385,353      |
| Accumulated other comprehensive loss:                                                                                        |              |              |
| Unrealized losses on investment securities and MBS available-for-sale, net of deferred income taxes of \$28,796 and \$20,021 | (49,152)     | (34,219)     |
| Retained earnings                                                                                                            | 134,005      | 120,695      |
| Total shareholders' equity                                                                                                   | 508,720      | 506,685      |
| Total liabilities and shareholders' equity                                                                                   | \$ 7,840,285 | \$ 7,558,928 |

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

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

|                                                              | Three Months Ended<br>March 31,               |           |
|--------------------------------------------------------------|-----------------------------------------------|-----------|
|                                                              | 2006                                          | 2005      |
|                                                              | (Dollars in thousands, except per share data) |           |
| Interest income:                                             |                                               |           |
| Loans                                                        | \$ 92,111                                     | \$ 68,043 |
| MBS                                                          | 23,345                                        | 23,082    |
| Investments and cash equivalents                             | 723                                           | 941       |
| Total interest income                                        | 116,179                                       | 92,066    |
| Interest expense:                                            |                                               |           |
| Deposits                                                     | 34,810                                        | 18,323    |
| Short-term borrowings                                        | 6,365                                         | 8,974     |
| Long-term borrowings                                         | 16,048                                        | 11,951    |
| Total interest expense                                       | 57,223                                        | 39,248    |
| Net interest income                                          | 58,956                                        | 52,818    |
| Provision for losses on loans                                | (4,650)                                       | (3,750)   |
| Net interest income after provision for losses on loans      | 54,306                                        | 49,068    |
| Non-interest income:                                         |                                               |           |
| Fees and service charges                                     | 9,079                                         | 7,403     |
| Mortgage banking operations                                  | 2,271                                         | 5,372     |
| Loan servicing fees                                          | 269                                           | 137       |
| Net losses on sales of securities                            | 0                                             | (57)      |
| Real estate owned and other collateralized assets operations | 307                                           | 112       |
| BOLI                                                         | 1,183                                         | 1,060     |
| Gain related to early repayment of debt                      | 0                                             | 645       |
| Other non-interest expense                                   | (192)                                         | (33)      |
| Total non-interest income                                    | 12,917                                        | 14,639    |
| Non-interest expenses                                        | 44,240                                        | 39,647    |
| Income before income taxes                                   | 22,983                                        | 24,060    |
| Income tax provision                                         | (7,567)                                       | (8,169)   |
| Net income                                                   | \$ 15,416                                     | \$ 15,891 |

|                                     |         |    |            |    |            |
|-------------------------------------|---------|----|------------|----|------------|
| Earnings per share                  | basic   | \$ | 0.44       | \$ | 0.46       |
| Earnings per share                  | diluted | \$ | 0.44       | \$ | 0.45       |
| Weighted average shares outstanding | basic   |    | 34,946,649 |    | 34,484,822 |
| Weighted average shares outstanding | diluted |    | 35,255,602 |    | 34,979,051 |

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

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

|                                                                                   | Three Months Ended<br>March 31, |           |
|-----------------------------------------------------------------------------------|---------------------------------|-----------|
|                                                                                   | 2006                            | 2005      |
|                                                                                   | (Dollars in thousands)          |           |
| Cash flows from operating activities:                                             |                                 |           |
| Net income                                                                        | \$ 15,416                       | \$ 15,891 |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                 |           |
| Provisions for losses on loans and real estate owned                              | 4,670                           | 3,750     |
| Stock dividends on FHLB Seattle stock                                             | 0                               | (303)     |
| Net gain on sales of loans, investment securities and MBS                         | (591)                           | (3,818)   |
| Stock issuances relating to 401(k) match and other                                | 820                             | 0         |
| Other gains and losses                                                            | (15)                            | (16,459)  |
| Change in cash surrender value of BOLI                                            | (1,183)                         | (1,060)   |
| Depreciation and amortization                                                     | 4,586                           | 3,991     |
| Change in:                                                                        |                                 |           |
| Accrued interest receivable                                                       | (1,157)                         | (1,291)   |
| Prepaid expenses and other assets                                                 | 3,367                           | 11,155    |
| Cashiers checks issued and payable                                                | 1,216                           | 2,389     |
| Accrued interest payable                                                          | 5,367                           | 390       |
| Accrued expenses and other liabilities                                            | (2,278)                         | (3,428)   |
| Proceeds from sales of loans originated for sale                                  | 31,376                          | 12,869    |
| Loans originated for sale                                                         | (30,785)                        | (12,283)  |
| Net cash provided by operating activities                                         | 30,809                          | 11,793    |
| Cash flows from investing activities:                                             |                                 |           |
| Change in restricted cash                                                         | (105)                           | 64        |
| Loans funded and purchased                                                        | (1,013,695)                     | (782,168) |
| Loan principal received                                                           | 638,276                         | 520,835   |
| Proceeds from sales of other loans                                                | 0                               | 133,259   |
| Purchase of investment securities                                                 | (12,359)                        | (5,181)   |
| Proceeds from maturities of investment securities                                 | 647                             | 190       |
| Proceeds from sales of investment securities                                      | 0                               | 14,844    |
| Purchase of mortgage-backed securities                                            | 0                               | (153,188) |
| Principal payments on mortgage-backed securities                                  | 68,028                          | 85,739    |
| Proceeds from sales of mortgage-backed securities                                 | 0                               | 115,837   |
| Purchase of office properties and equipment                                       | (3,664)                         | (2,780)   |
| Sales of office properties and equipment                                          | 77                              | 249       |
| Improvements and other changes to real estate owned                               | (229)                           | (17)      |
| Proceeds from sales and liquidation of real estate owned                          | 371                             | 898       |
| Net cash used in investing activities                                             | (322,653)                       | (71,419)  |

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



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

|                                                                                       | Three Months Ended<br>March 31, |            |
|---------------------------------------------------------------------------------------|---------------------------------|------------|
|                                                                                       | 2006                            | 2005       |
|                                                                                       | (Dollars in thousands)          |            |
| Cash flows from financing activities:                                                 |                                 |            |
| Net change in checking, regular savings and money market deposits                     | \$ 63,201                       | \$ 67,042  |
| Proceeds from issuance of time deposits                                               | 883,864                         | 615,725    |
| Payments for maturing time deposits                                                   | (697,332)                       | (453,708)  |
| Interest credited to deposits                                                         | 29,268                          | 15,955     |
| Advances from FHLB Seattle                                                            | 573,747                         | 320,229    |
| Repayment of advances from FHLB Seattle                                               | (646,036)                       | (428,596)  |
| Net change in securities sold subject to repurchase agreements and funds purchased    | 48,744                          | (35,132)   |
| Proceeds from other borrowings                                                        | 20,000                          | 0          |
| Repayment of other borrowings                                                         | 0                               | (14,000)   |
| Proceeds from exercise of stock options, net of repurchases                           | 2,838                           | 1,509      |
| Deferred financing costs                                                              | 0                               | (75)       |
| Cash dividend paid to shareholders                                                    | (1,917)                         | 0          |
| Other                                                                                 | 915                             | 1,534      |
| Net cash provided by financing activities                                             | 277,292                         | 90,483     |
| Net change in cash and cash equivalents                                               | (14,552)                        | 30,857     |
| Cash and cash equivalents, beginning of period                                        | 131,307                         | 93,187     |
| Cash and cash equivalents, end of period                                              | \$ 116,755                      | \$ 124,044 |
| Supplemental disclosures:                                                             |                                 |            |
| Cash paid during the period for:                                                      |                                 |            |
| Interest                                                                              | \$ 51,855                       | \$ 38,858  |
| Income taxes                                                                          | 0                               | (1,647)    |
| Noncash financing and investing activities:                                           |                                 |            |
| Loans converted into real estate owned and other collateralized assets                | 4,227                           | 334        |
| Common stock cash dividends accrued                                                   | 2,106                           | 0          |
| The accompanying notes are an integral part of the consolidated financial statements. |                                 |            |

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

|                                                                                            | Three Months Ended<br>March 31, |           |
|--------------------------------------------------------------------------------------------|---------------------------------|-----------|
|                                                                                            | 2006                            | 2005      |
|                                                                                            | (Dollars in thousands)          |           |
| Net income                                                                                 | \$ 15,416                       | \$ 15,891 |
| Other comprehensive income:                                                                |                                 |           |
| Change in unrealized gains (losses) on investment securities and MBS<br>available-for-sale | (23,708)                        | (26,456)  |
| Less deferred income taxes                                                                 | 8,775                           | 9,792     |
| Net other comprehensive income (loss)                                                      | (14,933)                        | (16,664)  |
| Comprehensive income (loss)                                                                | \$ 483                          | \$ (773)  |

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

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**STERLING FINANCIAL CORPORATION**  
**Notes to Consolidated Financial Statements**

**1. Basis of Presentation:**

The foregoing unaudited interim consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X as promulgated by the Securities and Exchange Commission. Accordingly, these financial statements do not include all of the disclosures required by accounting principles generally accepted in the United States of America for complete financial statements. These unaudited interim consolidated financial statements should be read in conjunction with the audited consolidated financial statements for the year ended December 31, 2005. In the opinion of management, the unaudited interim consolidated financial statements furnished herein include all adjustments, all of which are of a normal recurring nature, necessary for a fair statement of the results for the interim periods presented.

The preparation of financial statements in accordance with accounting principles generally accepted in the United States of America requires the use of estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities known to exist as of the date the financial statements are published, and the reported amounts of revenues and expenses during the reporting period. Uncertainties with respect to such estimates and assumptions are inherent in the preparation of Sterling Financial Corporation's consolidated financial statements; accordingly, it is possible that the actual results could differ from these estimates and assumptions, which could have a material effect on the reported amounts of Sterling's consolidated financial position and results of operations.

**2. Other Borrowings:**

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

|                                           | March 31,<br>2006 | December<br>31,<br>2005 |
|-------------------------------------------|-------------------|-------------------------|
| Term note payable <sup>(1)</sup>          | \$ 20,000         | \$ 0                    |
| Trust Preferred Securities <sup>(2)</sup> | 108,712           | 108,707                 |
| Other <sup>(3)</sup>                      | 454               | 1,981                   |
| Total                                     | \$ 129,166        | \$ 110,688              |

<sup>(1)</sup> On May 18, 2005, Sterling entered into a \$40 million variable-rate credit agreement (the Credit Facility) with Bank of Scotland. Amounts loaned pursuant to the Credit Facility currently bear interest at the 30 day LIBOR

plus 1.50%. The Credit Facility is secured by a majority of the preferred stock of Sterling's wholly owned subsidiary, Sterling Savings Bank. The Credit Facility contains representations and warranties, and negative and affirmative covenants by Sterling, including financial covenants and restrictions on certain actions by Sterling, such as Sterling's ability to incur debt, make investments and make acquisitions of other entities. Sterling is obligated to commence repayment of any loan principal on the third anniversary of the date Sterling entered into the Credit Facility, and is permitted to prepay loan principal without penalty. No amounts borrowed and repaid under the Credit Facility

may be  
reborrowed. As  
of March 31,  
2006,  
\$20 million had  
been advanced  
to Sterling  
under the Credit  
Facility.

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**2. Other Borrowings, continued:**

- (2) Sterling raises capital from time to time through the formation of trusts ( Capital Trusts ), which issue capital securities ( Trust Preferred Securities ) to investors. Sterling has also acquired Capital Trusts in connection with business acquisitions. These Capital Trusts are business trusts in which Sterling owns all of the common equity. The proceeds from the sale of the Trust Preferred Securities are used to purchase junior subordinated deferrable interest debentures ( Junior Subordinated Debentures ) issued by Sterling. Sterling's obligations under the Junior Subordinated Debentures and related

documents, taken together, constitute a full and unconditional guarantee by Sterling of the Capital Trusts obligations under the Trust Preferred Securities. The Trust Preferred Securities are treated as debt of Sterling. The Junior Subordinated Debentures and related Trust Preferred Securities generally mature 30 years after issuance and are redeemable at the option of Sterling under certain conditions, including, with respect to certain of the Trust Preferred Securities, payment of call premiums. Interest is paid quarterly or semi-annually. Details of the Trust Preferred Securities are as follows:

| <b>Subsidiary Issuer</b> | <b>Issue Date</b> | <b>Maturity Date</b> | <b>Call Date</b> | <b>Mandatorily Redeemable Capital Security</b> | <b>Rate Index</b> | <b>Rate at March 31, 2006</b> | <b>Carrying Value (in thousands)</b> |
|--------------------------|-------------------|----------------------|------------------|------------------------------------------------|-------------------|-------------------------------|--------------------------------------|
|--------------------------|-------------------|----------------------|------------------|------------------------------------------------|-------------------|-------------------------------|--------------------------------------|

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|                       |               |               |               |                                          |                                               |        |            |
|-----------------------|---------------|---------------|---------------|------------------------------------------|-----------------------------------------------|--------|------------|
| Sterling Capital      | June<br>2003  | Sept<br>2033  | Sept<br>2008  | Floating Rate<br>Capital<br>Securities   | 3 month<br>LIBOR<br>plus<br>3.20%             | 8.11%  | \$ 10,310  |
| Trust VI              | May<br>2003   | May<br>2033   | June<br>2008  | Floating Rate<br>Capital<br>Securities   | 3 month<br>LIBOR<br>plus<br>3.25%             | 8.21%  | 20,619     |
| Sterling Capital      | May<br>2003   | May<br>2033   | May<br>2008   | Floating Rate<br>Preferred<br>Securities | 3 month<br>LIBOR<br>plus<br>3.15%             | 7.90%  | 10,310     |
| Statutory Trust V     | April<br>2003 | April<br>2033 | April<br>2008 | Floating Rate<br>Capital<br>Securities   | 3 month<br>LIBOR<br>plus<br>3.25%             | 7.93%  | 14,433     |
| Sterling Capital      | April<br>2003 | April<br>2033 | April<br>2008 | Floating Rate<br>Capital<br>Securities   | 6 month<br>LIBOR<br>plus<br>3.70%             | 8.15%  | 13,146     |
| Trust III             | April<br>2002 | April<br>2032 | April<br>2007 | Floating Rate<br>Capital<br>Securities   | 6 month<br>LIBOR<br>plus<br>3.75%             | 8.56%  | 15,151     |
| Klamath First Capital | July<br>2001  | July<br>2031  | June<br>2006  | Floating Rate<br>Capital<br>Securities   | 10.25%<br>Cumulative<br>Capital<br>Securities | Fixed  | 24,743     |
| Trust II              | July<br>2001  | July<br>2031  | June<br>2006  |                                          |                                               | 8.64%* | \$ 108,712 |

\* weighted  
average rate

**Table of Contents****2. Other Borrowings, continued:**

- (3) During 2002, Sterling financed the sale of certain loans to an unrelated party. Since the underlying loans served as collateral on the loan to the purchaser, this sale was accounted for as a financing.

**3. Earnings Per Share:**

The following table presents the basic and diluted earnings per share computations. All per share amounts reflect the 3 for 2 stock split that was effected on August 31, 2005.

|                                                                 | Three Months Ended March 31, |                         |                        |               |                         |                        |
|-----------------------------------------------------------------|------------------------------|-------------------------|------------------------|---------------|-------------------------|------------------------|
|                                                                 | 2006                         |                         |                        | 2005          |                         |                        |
|                                                                 | Net<br>Income                | Weighted<br>Avg. Shares | Per<br>Share<br>Amount | Net<br>Income | Weighted<br>Avg. Shares | Per<br>Share<br>Amount |
| (Dollars in thousands, except per share amounts)                |                              |                         |                        |               |                         |                        |
| Basic computations                                              | \$ 15,416                    | 34,946,649              | \$ 0.44                | \$ 15,891     | 34,484,822              | \$ 0.46                |
| Effect of dilutive securities:                                  |                              |                         |                        |               |                         |                        |
| Common stock options                                            | 0                            | 308,953                 | 0.00                   | 0             | 458,217                 | (0.01)                 |
| Contingently issuable shares                                    | 0                            | 0                       | 0.00                   | 0             | 36,012                  | 0.00                   |
| Diluted computations                                            | \$ 15,416                    | 35,255,602              | \$ 0.44                | \$ 15,891     | 34,979,051              | \$ 0.45                |
| Antidilutive options not included in diluted earnings per share |                              | 0                       |                        |               | 456,000                 |                        |

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

|                                          | Three Months Ended<br>March 31, |           |
|------------------------------------------|---------------------------------|-----------|
|                                          | 2006                            | 2005      |
|                                          | (Dollars in thousands)          |           |
| Employee compensation and benefits       | \$ 25,089                       | \$ 22,017 |
| Occupancy and equipment                  | 6,916                           | 6,046     |
| Depreciation                             | 2,283                           | 2,015     |
| Amortization of core deposit intangibles | 556                             | 556       |
| Advertising                              | 1,921                           | 2,072     |
| Data processing                          | 3,332                           | 3,175     |
| Insurance                                | 283                             | 304       |
| Legal and accounting                     | 535                             | 976       |
| Travel and entertainment                 | 1,142                           | 957       |
| Goodwill litigation costs                | 85                              | 68        |
| Other                                    | 2,098                           | 1,461     |
| Total                                    | \$ 44,240                       | \$ 39,647 |

**5. Segment Information:**

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

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

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

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

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

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

**Table of Contents****5. Segment Information, continued:**

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

|                                  | As of and for the Three Months Ended March 31, 2006 |                                    |                                   |                     |                           |              |
|----------------------------------|-----------------------------------------------------|------------------------------------|-----------------------------------|---------------------|---------------------------|--------------|
|                                  | Community<br>Banking                                | Residential<br>Mortgage<br>Banking | Commercial<br>Mortgage<br>Banking | Retail<br>Brokerage | Other and<br>Eliminations | Total        |
|                                  | (Dollars in thousands)                              |                                    |                                   |                     |                           |              |
| Interest income                  | \$ 110,540                                          | \$ 3,467                           | \$ 1,857                          | \$ 0                | \$ 315                    | \$ 116,179   |
| Interest expense                 | (55,082)                                            | 0                                  | 0                                 | 0                   | (2,141)                   | (57,223)     |
| Net interest income<br>(expense) | 55,458                                              | 3,467                              | 1,857                             | 0                   | (1,826)                   | 58,956       |
| Provision for loan<br>losses     | (4,650)                                             | 0                                  | 0                                 | 0                   | 0                         | (4,650)      |
| Noninterest income               | 11,454                                              | 2,087                              | 1,237                             | 828                 | (2,689)                   | 12,917       |
| Noninterest expense              | (37,440)                                            | (3,816)                            | (1,868)                           | (711)               | (405)                     | (44,240)     |
| Income before income<br>taxes    | \$ 24,822                                           | \$ 1,738                           | \$ 1,226                          | \$ 117              | \$ (4,920)                | \$ 22,983    |
| Total assets                     | \$ 7,886,858                                        | \$ 12,752                          | \$ 8,581                          | \$ 705              | \$ (68,611)               | \$ 7,840,285 |

|                                  | As of and for the Three Months Ended March 31, 2005 |                                    |                                   |                     |                           |              |
|----------------------------------|-----------------------------------------------------|------------------------------------|-----------------------------------|---------------------|---------------------------|--------------|
|                                  | Community<br>Banking                                | Residential<br>Mortgage<br>Banking | Commercial<br>Mortgage<br>Banking | Retail<br>Brokerage | Other and<br>Eliminations | Total        |
|                                  | (Dollars in thousands)                              |                                    |                                   |                     |                           |              |
| Interest income                  | \$ 87,856                                           | \$ 2,419                           | \$ 1,791                          | \$ 0                | \$ 0                      | \$ 92,066    |
| Interest expense                 | (37,298)                                            | 0                                  | 0                                 | 0                   | (1,950)                   | (39,248)     |
| Net interest income<br>(expense) | 50,558                                              | 2,419                              | 1,791                             | 0                   | (1,950)                   | 52,818       |
| Provision for loan<br>losses     | (3,750)                                             | 0                                  | 0                                 | 0                   | 0                         | (3,750)      |
| Noninterest income               | 13,650                                              | 2,229                              | 1,431                             | 805                 | (3,476)                   | 14,639       |
| Noninterest expense              | (33,588)                                            | (4,165)                            | (1,365)                           | (790)               | 261                       | (39,647)     |
| Income before income<br>taxes    | \$ 26,870                                           | \$ 483                             | \$ 1,857                          | \$ 15               | \$ (5,165)                | \$ 24,060    |
| Total assets                     | \$ 7,080,305                                        | \$ 21,295                          | \$ 20,449                         | \$ 1,273            | \$ (108,815)              | \$ 7,014,507 |

**Table of Contents****6. Stock Options:**

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

During the three months ended March 31, 2006, no stock options were issued or vested. Thus, no stock based compensation expense was recognized. Management is currently evaluating what form, if any, of share based compensation it will implement. Had SFAS 123 (R) been effective during the three months ended March 31, 2005, \$35,000 of stock based compensation expense would have been recognized. The Black-Scholes option-pricing model was used in estimating the fair value of option grants. The weighted average assumptions used are presented in the table below. The expected forfeiture rate was based upon historical and projected data that resulted in a rate of less than 1%.

|                           | Three Months<br>Ended<br>March 31, 2005 |       |
|---------------------------|-----------------------------------------|-------|
| Expected volatility       | 37%                                     | 132%  |
| Expected lives (in years) | 4                                       | 10    |
| Risk free interest rates  | 1.77%                                   | 6.52% |
| Expected forfeiture rate  |                                         | 0%    |
| Annual dividend yield     |                                         | 0%    |

**7. New Accounting Policies:**

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

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

In December 2004, the FASB issued SFAS No. 123 (revised 2004), Share-Based Payment, which established accounting standards for transactions involving the issuance of equity instruments to employees for services rendered. This statement is a revision of SFAS No. 123, and supersedes APB No. 25. This statement requires the estimation and recognition of the grant date fair value of stock options issued to employees. This statement became effective for Sterling as of January 1, 2006. Management has evaluated the effect of this new standard, and has determined that the fair value of currently outstanding unvested stock options will not have a material effect on



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Sterling's consolidated financial statements. Management is currently evaluating what form, if any, of share based compensation it will implement in the future.

### **8. Derivatives and Hedging:**

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

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

Rate locks and forward sales agreements on held-for-sale loans are considered to be derivatives. Sterling has recorded the estimated fair values of these rate locks and forward sales agreements on its balance sheet in either other assets or other liabilities. Changes in the fair values of these derivative instruments are recorded in income from mortgage banking operations in the income statement as the changes occur. The estimated fair value of rate locks and forward sales commitments were greater than the contracted amounts at March 31, 2006, which resulted in assets of \$48,000 and \$57,000, respectively. At December 31, 2005, rate locks and forward sales commitments were assets of \$147,000 and \$25,000, respectively.

### **9. Stock Split and Cash Dividends:**

On July 26, 2005, Sterling announced a 3 for 2 stock split, which was effected on August 31, 2005 to shareholders of record as of August 17, 2005. This split was effected in the form of a 50% stock dividend and resulted in 11,553,249 shares of common stock being issued. All per share amounts reflect this split. In October 2005, Sterling paid its first quarterly cash dividend of \$0.05 per share, or \$1.7 million. In January 2006, Sterling paid a quarterly cash dividend of \$0.055 per share, or \$1.9 million. In February 2006, Sterling announced a quarterly cash dividend of \$0.06 per share, or \$2.1 million, payable on April 13, 2006 to shareholders of record as of March 31, 2006. Subsequent to the quarter, in April 2006, Sterling announced a quarterly cash dividend of \$0.065 per share, payable on July 14, 2006 to shareholders of record as of June 30, 2006. The board of directors of Sterling from time to time evaluates the payment of cash dividends. The timing and amount of any future dividends will depend upon earnings, cash requirements, capital requirements, the financial condition of Sterling and its subsidiaries, applicable government regulations and other factors deemed relevant by Sterling's board of directors.

### **10. Business Combinations:**

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

### **11. Subsequent Event:**

Subsequent to the quarter, in April 2006, Sterling announced a quarterly cash dividend of \$0.065 per share, payable on July 14, 2006 to shareholders of record as of June 30, 2006.

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**PART I Financial Information (continued)**

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

**STERLING FINANCIAL CORPORATION**

**Comparison of the Three Months Ended March 31, 2006**

*This report contains forward-looking statements. For a discussion about such statements, including the risks and uncertainties inherent therein, see Forward-Looking Statements. Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with the Consolidated Financial Statements and Notes presented elsewhere in this report and in Sterling's 2005 annual report on Form 10-K.*

**General**

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

Sterling provides personalized, quality financial services to its customers as exemplified by its Hometown Helpful philosophy and Perfect Fit banking products. Sterling believes that this dedication to personalized service has enabled it to grow both its retail deposit base and its lending portfolio in the western region. With \$7.84 billion in total assets at March 31, 2006, Sterling originates loans and attracts Federal Deposit Insurance Corporation (FDIC) insured deposits from the general public through 142 financial service centers located throughout the western region of the United States. Sterling also originates loans through Action Mortgage residential loan production offices and through INTERVEST commercial real estate lending offices in the western region. Sterling also markets fixed income and equity products, mutual funds, fixed and variable annuities and other financial products through Harbor Financial service representatives located throughout Sterling's financial service center network.

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

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**Executive Summary and Highlights**

Sterling's earnings of \$15.4 million, or \$0.44 per diluted share, for the first quarter of 2006 represented a 3.0% decrease from earnings of \$15.9 million, or \$0.45 per diluted share, for the prior year's comparable quarter. The decrease in net income mainly reflected a greater proportional increase in non-interest expense relative to NII and non-interest income.

NII of \$59.0 million for the first quarter of 2006 represented a 12% increase over the 2005 amount, primarily due to increased average loan volumes. Sterling's net interest margin for the three months ended March 31, 2006 increased by 8 basis points from the first quarter of 2005. The increase in net interest margin for the quarter ended March 31, 2006 over the quarter ended March 31, 2005 was primarily attributed to higher average loan volumes.

Mortgage banking operations income decreased to \$2.3 million for the three months ended March 31, 2006 from \$5.4 million for the same period in 2005. Fees and service charges income increased by 23% to \$9.1 million from \$7.4 million for the quarter ended March 31, 2005. The decrease in mortgage banking operations income was primarily a result of lower volume of loan sales, as Sterling sold \$34.7 million in loans during the three months ended March 31, 2006, compared to \$168.7 million during the three months ended March 31, 2005. The increase in fees and service charges income did not fully offset the drop in mortgage banking operations income.

Sterling's loan originations for the quarter ended March 31, 2006 were \$1.07 billion, compared with \$822.6 million in the first quarter of 2005, a 30% increase. The majority of the growth occurred in construction and commercial lending. Highlights for the first quarter of 2006 were as follows:

Loan originations of \$1.07 billion reflect an increase of 30 percent over the first quarter of 2005.

Total loans receivable increased to a record \$5.25 billion.

Total deposits increased to a record \$5.09 billion.

The number of transaction accounts increased to nearly 156,000.

Fees and service charges income increased to \$9.1 million, a 23 percent increase over the first quarter of 2005.

Quarter-end non-performing assets, loan charge-offs, and delinquency ratios remain very low.

The Sterling Board of Directors approved a cash dividend of \$0.06 per common share, paid on April 13, 2006 to shareholders of record as of March 31, 2006.

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### **Company Growth**

Sterling intends to continue to pursue an aggressive growth strategy to become the leading community bank in the west. This strategy may include acquiring other financial businesses or branches thereof, or other substantial assets or deposit liabilities. Sterling may not be successful in identifying further acquisition candidates, integrating acquisitions or preventing such acquisitions from having an adverse effect on Sterling. There is significant competition for acquisitions in Sterling's market area, and Sterling may not be able to acquire other businesses on attractive terms. Furthermore, the success of Sterling's growth strategy will depend on increasing and maintaining sufficient levels of regulatory capital, obtaining necessary regulatory approvals, generating appropriate growth and the existence of favorable economic and market conditions. There can be no assurance that Sterling will be successful in implementing its growth strategy. On February 13, 2006, Sterling announced that it had entered into a definitive agreement to acquire Lynnwood Financial Group, Inc., the parent company of Golf Savings Bank, pursuant to which Lynnwood Financial Group, Inc. would merge with and into Sterling, with Sterling being the surviving entity. Lynnwood's subsidiaries, Golf Savings Bank and Golf Escrow Corporation, are expected to continue operations as wholly-owned subsidiaries of Sterling.

### **Critical Accounting Policies**

The accounting and reporting policies of Sterling conform to accounting principles generally accepted in the United States of America (GAAP) and to general practices within the banking industry. The preparation of the financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates. Sterling's management has identified the accounting policies described below as those that, due to the judgments, estimates and assumptions inherent in those policies are critical to an understanding of Sterling's Consolidated Financial Statements and Management's Discussion and Analysis.

***Income Recognition.*** Sterling recognizes interest income by methods that conform to general accounting practices within the banking industry. In the event management believes collection of all or a portion of contractual interest on a loan has become doubtful, which generally occurs after the loan is 90 days past due, Sterling discontinues the accrual of interest and any previously accrued interest recognized in income deemed uncollectible is reversed. Interest received on nonperforming loans is included in income only if principal recovery is reasonably assured. A nonperforming loan is restored to accrual status when it is brought current, has performed in accordance with contractual terms for a reasonable period of time, and the collectibility of the total contractual principal and interest is no longer in doubt.

***Allowance For Loan Losses.*** In general, determining the amount of the allowance for loan losses requires significant judgment and the use of estimates by management. Sterling maintains an allowance for loan losses to absorb probable losses in the loan portfolio based on a quarterly analysis of the portfolio and expected future losses. This analysis is designed to determine an appropriate level and allocation of the allowance for losses among loan types by considering factors affecting loan losses, including specific losses, levels and trends in impaired and nonperforming loans, historical loan loss experience, current national and local economic conditions, volume, growth and composition of the portfolio, regulatory guidance and other relevant factors. Management monitors the loan portfolio to evaluate the adequacy of the allowance. The allowance can increase or decrease each quarter based upon the results of management's analysis.

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

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

While management uses available information to provide for loan losses, the ultimate collectibility of a substantial portion of the loan portfolio and the need for future additions to the allowance will be based on changes in economic conditions and other relevant factors. A slowdown in economic activity could adversely affect cash flows for both commercial and individual borrowers, as a result of which Sterling could experience increases in nonperforming assets, delinquencies and losses on loans. There can be no assurance that the allowance for loan losses will be adequate to cover all losses, but management believes the allowance for loan losses was adequate at March 31, 2006.

**Investment Securities and MBS.** Assets in the investment securities and MBS portfolios are initially recorded at cost, which includes any premiums and discounts. Sterling amortizes premiums and discounts as an adjustment to interest income using the level interest yield method over the estimated life of the security. The cost of investment securities sold, and any resulting gain or loss, is based on the specific identification method.

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

Management determines the appropriate classification of investment securities at the time of purchase.

Held-to-maturity securities are those securities that Sterling has the positive intent and ability to hold to maturity and are recorded at amortized cost. Available-for-sale securities are those securities that would be available to be sold in the future in response to Sterling's liquidity needs, changes in market interest rates, and asset-liability management strategies, among others. Available-for-sale securities are reported at fair value, with unrealized holding gains and losses reported in shareholders' equity as a separate component of other comprehensive income, net of applicable deferred income taxes.

Management evaluates investment securities for other-than-temporary declines in fair value on a quarterly basis. If the fair value of investment securities falls below their amortized cost and the decline is deemed to be other-than-temporary, the securities will be written down to current market value, resulting in a loss recorded in the income statement and the establishment of a new basis. During the three months ended March 31, 2006, there were no investment securities that management identified to be other-than-temporarily impaired, because the decline in fair value was attributable to changes in interest rates and not credit quality, and because Sterling has the ability and intent to hold these investments until a recovery in market price occurs, or until maturity. Realized losses could occur in future periods due to a change in management's intent to hold the investments to maturity, a change in management's assessment of credit risk, or a change in regulatory or accounting requirements.

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

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

***Real Estate Owned and Other Collateralized Assets.*** Property and other assets acquired through foreclosure of defaulted mortgage or other collateralized loans are carried at the lower of cost or fair value, less estimated costs to sell. Development and improvement costs relating to such property are capitalized to the extent they are deemed to be recoverable.

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

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

Sterling uses an estimate of future earnings to support its position that the benefit of its net deferred 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**

***Overview.*** Sterling recorded net income of \$15.4 million, or \$0.44 per diluted share, for the three months ended March 31, 2006, compared with net income of \$15.9 million, or \$0.45 per diluted share, for the three months ended March 31, 2005. The decrease in net income for the first quarter of 2006 from the first quarter of 2005 mainly reflected a decrease in MBO income.

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The annualized return on average assets ( ROA ) was 0.81% and 0.91% for the three months ended March 31, 2006 and 2005, respectively. The annualized return on average equity ( ROE ) was 12.1% and 13.5% for the three months ended March 31, 2006 and 2005, respectively. The decrease in ROA and ROE compared to the first quarter of 2005 was due to increases in assets and equity outpacing net income.

**Net Interest Income.** The most significant component of earnings for a financial institution typically is NII, which is the difference between interest income, primarily from loan, MBS and investment securities portfolios, and interest expense, primarily on deposits and borrowings. During the three months ended March 31, 2006 and 2005, NII was \$59.0 million and \$52.8 million, respectively, an increase of 12%. The increase in NII during the first quarter of 2006 compared to the first quarter of 2005 was mainly due to increases in average loan volumes.

Changes in Sterling's NII are a function of changes in both rates and volumes of interest-earning assets and interest-bearing liabilities. Volume refers to the dollar level of interest-earning assets and interest-bearing liabilities. Net interest spread refers to the difference between the yield on interest-earning assets and the rate paid on interest-bearing liabilities. Net interest margin refers to NII divided by total average interest-earning assets and is influenced by the level and relative mix of interest-earning assets and interest-bearing liabilities.

The following table presents the composition of the change in NII for the periods presented. For each category of interest-earning assets and interest-bearing liabilities, the following table provides information on changes attributable to:

- changes in volume    changes in volume multiplied by comparative period rate;
- changes in rate    changes in rate multiplied by comparative period volume; and
- changes in rate/volume    changes in rate multiplied by changes in volume.

|                                  | Three Months Ended March 31,<br>2006 vs. 2005 |            |                 |           |
|----------------------------------|-----------------------------------------------|------------|-----------------|-----------|
|                                  | Increase (Decrease) Due to:                   |            |                 |           |
|                                  | Volume                                        | Rate       | Rate/<br>Volume | Total     |
|                                  | (Dollars in thousands)                        |            |                 |           |
| Rate/volume analysis:            |                                               |            |                 |           |
| Interest income:                 |                                               |            |                 |           |
| Loans                            | \$ 9,785                                      | \$ 12,530  | \$ 1,753        | \$ 24,068 |
| MBS                              | (606)                                         | 893        | (24)            | 263       |
| Investments and cash equivalents | 23                                            | (235)      | (6)             | (218)     |
| Total interest income            | 9,202                                         | 13,188     | 1,723           | 24,113    |
| Interest expense:                |                                               |            |                 |           |
| Deposits                         | 5,452                                         | 8,596      | 2,439           | 16,487    |
| Borrowings                       | (3,593)                                       | 6,137      | (1,056)         | 1,488     |
| Total interest expense           | 1,859                                         | 14,733     | 1,383           | 17,975    |
| Net changes in NII               | \$ 7,343                                      | \$ (1,545) | \$ 340          | \$ 6,138  |

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

|                    | Net Interest<br>Margin |
|--------------------|------------------------|
| Three Months Ended |                        |
| March 31, 2006     | 3.30%                  |
| December 31, 2005  | 3.32%                  |
| September 30, 2005 | 3.33%                  |
| June 30, 2005      | 3.26%                  |
| March 31, 2005     | 3.22%                  |

Average interest-earning assets for the three months ended March 31, 2006 and 2005 were \$7.24 billion and \$6.65 billion, respectively. Average loans increased by \$638.4 million, while average investment securities and MBS decreased by \$48.9 million over the 2005 amounts. Net interest spread during these periods were 3.19% and 3.17%, respectively. Net interest margin for the three months ended March 31, 2006 and 2005 was 3.30% and 3.22%, respectively, with the increase mainly attributable to a higher volume of average loans.

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

Sterling recorded provisions for losses on loans of \$4.7 million and \$3.8 million for the three months ended March 31, 2006 and 2005, respectively. The current provision reflects the analysis and assessment of the relevant factors mentioned in the preceding paragraph. Management anticipates that its provisions for losses on loans will continue to increase, reflecting Sterling's strategic direction of originating more commercial real estate, construction, business banking and consumer loans that have a somewhat higher loss profile than Sterling's historical mix of loans.

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

|                                                 | Three Months Ended March 31, |          |
|-------------------------------------------------|------------------------------|----------|
|                                                 | 2006                         | 2005     |
|                                                 | (Dollars in thousands)       |          |
| Balance at January 1                            | \$55,483                     | \$49,362 |
| Provision for losses on loans                   | 4,650                        | 3,750    |
| Amounts written off net of recoveries and other | (1,434)                      | (400)    |
| Balance at March 31                             | \$58,699                     | \$52,712 |

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At March 31, 2006, Sterling's total classified assets were 0.70% of total assets, compared with 0.79% of total assets at December 31, 2005 and 1.03% of total assets at March 31, 2005. Nonperforming assets were 0.13% of total assets at March 31, 2006, compared with 0.11% of total assets at December 31, 2005 and 0.26% of total assets at March 31, 2005. Sterling does not anticipate significant losses in these classified assets, although there can be no assurances in this regard. At March 31, 2006, the loan delinquency ratio was 0.08% of total loans compared to 0.18% at December 31, 2005 and 0.37% of total loans at March 31, 2005. Asset quality has been stable over the periods presented.

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

|                                           | Three Months Ended<br>March 31, |           |          |
|-------------------------------------------|---------------------------------|-----------|----------|
|                                           | 2006                            | 2005      | % Change |
|                                           | (Dollars in thousands)          |           |          |
| Fees and service charges                  | \$ 9,079                        | \$ 7,403  | 22.6     |
| Mortgage banking operations               | 2,271                           | 5,372     | (57.7)   |
| Loan servicing fees                       | 269                             | 137       | 96.4     |
| Net gains (losses) on sales of securities | 0                               | (57)      | (100.0)  |
| Real estate owned operations              | 307                             | 112       | 174.1    |
| BOLI                                      | 1,183                           | 1,060     | 11.6     |
| Gain on early extinguishment of debt      | 0                               | 645       | (100.0)  |
| Other non-interest expense                | (192)                           | (33)      | (481.8)  |
| Total                                     | \$ 12,917                       | \$ 14,639 | (11.8)   |

The decrease in non-interest income was primarily due to a decrease in income from mortgage banking operations. The decrease reflected a \$134.0 million decrease in loan sales during the first quarter of 2006 compared to the first quarter of 2005. The 2005 activity reflected the sale of certain thrift like assets, as well as the realization of market demand for these loans. Fees and service charges increased 23% over the 2005 quarter, primarily due to the growth in transaction accounts.

During the quarter ended March 31, 2006, Sterling did not sell any investment securities or MBS, compared with \$130.7 million for the quarter ended March 31, 2005. There were no sales during the March 2006 quarter as a result of management's response to market conditions and portfolio management needs.

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

|                                                                        | As of and for the<br>Three Months Ended<br>March 31, |            |
|------------------------------------------------------------------------|------------------------------------------------------|------------|
|                                                                        | 2006                                                 | 2005       |
|                                                                        | (Dollars in thousands)                               |            |
| Originations of residential mortgage loans                             | \$ 71,097                                            | \$ 156,483 |
| Originations of commercial real estate loans                           | 33,975                                               | 55,055     |
| Sales of residential mortgage loans                                    | 34,732                                               | 136,280    |
| Sales of commercial real estate loans                                  | 0                                                    | 32,413     |
| Principal balances of residential loans serviced for others            | 594,110                                              | 447,154    |
| Principal balances of commercial real estate loans serviced for others | 820,845                                              | 619,644    |

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

|                                          | Three Months Ended<br>March 31, |           | %<br>Change |
|------------------------------------------|---------------------------------|-----------|-------------|
|                                          | 2006                            | 2005      |             |
|                                          | (Dollars in thousands)          |           |             |
| Employee compensation and benefits       | \$ 25,089                       | \$ 22,017 | 14.0        |
| Occupancy and equipment                  | 6,916                           | 6,046     | 14.4        |
| Depreciation                             | 2,283                           | 2,015     | 13.3        |
| Amortization of core deposit intangibles | 556                             | 556       | 0.0         |
| Advertising                              | 1,921                           | 2,072     | (7.3)       |
| Data processing                          | 3,332                           | 3,175     | 4.9         |
| Insurance                                | 283                             | 304       | (6.9)       |
| Legal and accounting                     | 535                             | 976       | (45.2)      |
| Travel and entertainment                 | 1,142                           | 957       | 19.3        |
| Goodwill litigation costs                | 85                              | 68        | 25.0        |
| Other                                    | 2,098                           | 1,461     | 43.6        |
| Total                                    | \$ 44,240                       | \$ 39,647 | 11.6        |

The increases in non-interest expenses were primarily due to higher employee compensation and benefits, as well as occupancy and equipment expenses, mainly as a result of overall company growth. Full-time equivalent employees increased year-over-year by 192 to 1,832 at March 31, 2006.

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**Income Tax Provision.** Sterling recorded federal and state income tax provisions of \$7.6 million and \$8.2 million for the three months ended March 31, 2006 and 2005, respectively. The effective tax rate for the three month comparative period was 32.9% and 34.0%, respectively. The decrease in the effective tax rate primarily reflects increases in tax credits received as a result of Sterling's participation in low income housing partnerships.

**Financial Position**

**Assets.** At March 31, 2006, Sterling's assets were \$7.84 billion, up \$281.4 million from \$7.56 billion at December 31, 2005. This growth was mainly a result of increases in the loan portfolio through originations.

**Investment Securities and MBS.** Sterling's investment and MBS portfolio at March 31, 2006 was \$2.05 billion, a decrease of \$81.8 million from the December 31, 2005 balance of \$2.13 billion. The decrease was mainly due to principal repayments and maturities. On March 31, 2006, the investment and MBS portfolio had an unrealized loss of \$77.8 million versus an unrealized loss of \$54.1 million at December 31, 2005, with the fluctuation primarily due to an increase in interest rates.

**Loans Receivable.** At March 31, 2006, net loans receivable were \$5.25 billion, up \$363.6 million from \$4.89 billion at December 31, 2005. The increase was due to loan originations during the period, net of loan repayments.

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

|                               | March 31, 2006         |       | December 31, 2005 |       |
|-------------------------------|------------------------|-------|-------------------|-------|
|                               | Amount                 | %     | Amount            | %     |
|                               | (Dollars in thousands) |       |                   |       |
| Residential real estate       | \$ 497,386             | 9.4   | \$ 488,633        | 9.9   |
| Multifamily real estate       | 330,427                | 6.2   | 332,211           | 6.7   |
| Commercial real estate        | 786,215                | 14.8  | 792,219           | 16.0  |
| Construction                  | 1,261,061              | 23.7  | 1,021,502         | 20.6  |
| Consumer direct               | 640,941                | 12.1  | 618,528           | 12.5  |
| Consumer indirect             | 177,013                | 3.3   | 166,143           | 3.4   |
| Business banking              | 1,128,397              | 21.2  | 1,079,939         | 21.8  |
| Corporate banking             | 496,851                | 9.3   | 451,140           | 9.1   |
| Gross loans receivable        | 5,318,291              | 100.0 | 4,950,315         | 100.0 |
| Net deferred origination fees | (10,077)               |       | (8,916)           |       |
| Allowance for losses on loans | (58,699)               |       | (55,483)          |       |
| Loans receivable, net         | \$ 5,249,515           |       | \$ 4,885,916      |       |

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

|                         |              | Three Months Ended<br>March 31, | %<br>Change |
|-------------------------|--------------|---------------------------------|-------------|
|                         | 2006         | 2005<br>(Dollars in thousands)  |             |
| Residential real estate | \$ 71,097    | \$ 156,483                      | (54.6)      |
| Multifamily real estate | 0            | 13,267                          | (100.0)     |
| Commercial real estate  | 33,975       | 55,055                          | (38.3)      |
| Construction            | 563,592      | 344,920                         | 63.4        |
| Consumer direct         | 78,849       | 63,951                          | 23.3        |
| Consumer indirect       | 29,535       | 15,042                          | 96.4        |
| Business banking        | 176,449      | 94,148                          | 87.4        |
| Corporate banking       | 119,511      | 79,733                          | 49.9        |
| Total loans originated  | \$ 1,073,008 | \$ 822,599                      | 30.4        |

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

|                              | March 31, 2006         |       | December 31, 2005 |       |
|------------------------------|------------------------|-------|-------------------|-------|
|                              | Amount                 | %     | Amount            | %     |
|                              | (Dollars in thousands) |       |                   |       |
| Interest-bearing checking    | \$ 410,780             | 8.1   | \$ 432,936        | 9.0   |
| Noninterest-bearing checking | 676,857                | 13.3  | 673,934           | 14.0  |
| Savings                      | 1,403,730              | 27.6  | 1,312,033         | 27.3  |
| Time deposits                | 2,593,935              | 51.0  | 2,387,398         | 49.7  |
| Total deposits               | \$ 5,085,302           | 100.0 | \$ 4,806,301      | 100.0 |

Total deposits increased to \$5.09 billion at March 31, 2006 from \$4.81 billion at December 31, 2005. Deposit growth was primarily in time and savings accounts, mainly reflecting the higher interest rate environment, consumer's increased demand for products and services, and Sterling's use of brokered CD's as a cost competitive source of funds.

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***Borrowings.*** Deposit accounts are Sterling's primary source of funds. Sterling does, however, rely upon advances from the Federal Home Loan Bank Seattle ( FHLB Seattle ), reverse repurchase agreements ( REPOs ) and other borrowings to fund asset growth and meet deposit withdrawal requirements. During the three months ended March 31, 2006, the gross fluctuation in these funding sources were relatively flat, with the aggregate total of FHLB advances, REPOs and Fed funds purchased decreasing a net \$23.6 million, largely offset by a \$20.0 million draw down from Sterling's line of credit with the Bank of Scotland. See Liquidity and Capital Resources.

**Asset and Liability Management**

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

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

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

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

Sterling is continuing to pursue strategies to manage the level of its IRR while increasing its NII: a) through the origination and retention of variable-rate consumer, business banking, construction and commercial real estate loans, which generally have higher yields than residential permanent loans; b) by retaining fewer long-term fixed rate mortgages and not replacing certain long-term fixed rate mortgage investments that have been repaid; and c) by increasing the level of its core deposits, which are generally a lower-cost funding source than wholesale borrowings. There can be no assurance that Sterling will be successful implementing any of these strategies or that, if these strategies are implemented, they will have the intended effect of reducing IRR or increasing NII.

The following table indicates the sensitivity of Sterling's NII for the periods indicated and for meaningful changes in interest rates. The results reflect the potential effects of instantaneous, parallel shifts in the market yield curve on a static balance sheet with a flat interest rate forecast. These calculations are highly subjective and technical and are relative measurements of IRR, which do not necessarily reflect any expected rate movement. The following are projections four quarters from the indicated balance sheet dates:

| Change in<br>Interest Rate in<br>Basis Points<br>(Rate Shock) | March 31,<br>2006<br>% Change in<br>NII | December 31,<br>2005<br>% Change in<br>NII |
|---------------------------------------------------------------|-----------------------------------------|--------------------------------------------|
| +300                                                          | (3.7)                                   | (7.3)                                      |
| +200                                                          | (2.6)                                   | (4.6)                                      |
| +100                                                          | (1.3)                                   | (2.4)                                      |
| Static                                                        | 0.0                                     | 0.0                                        |
| -100                                                          | (1.4)                                   | (0.5)                                      |
| -200                                                          | (6.3)                                   | (5.2)                                      |
| -300                                                          | (12.9)                                  | (7.0)                                      |

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

| Change in<br>Interest Rate<br>in Basis Points<br>(Rate Shock) | At March 31, 2006 |                                                    |                  | At December 31, 2005 |                                |                  |
|---------------------------------------------------------------|-------------------|----------------------------------------------------|------------------|----------------------|--------------------------------|------------------|
|                                                               | NPV               | Ratio of NPV<br>to the Present                     | %                | NPV                  | Ratio of NPV<br>to the Present | %                |
|                                                               |                   | Value of<br>Total Assets<br>(Dollars in thousands) | Change<br>in NPV |                      | Value of<br>Total Assets       | Change<br>in NPV |
| +300                                                          | \$732,671         | 9.26%                                              | (12.9)           | \$697,159            | 9.16%                          | (13.5)           |
| +200                                                          | 773,697           | 9.69                                               | (8.0)            | 748,211              | 9.74                           | (7.1)            |
| +100                                                          | 810,980           | 10.08                                              | (3.6)            | 777,474              | 10.04                          | (3.5)            |
| Static                                                        | 840,885           | 10.37                                              | 0.0              | 805,739              | 10.32                          | 0.0              |
| -100                                                          | 811,409           | 9.99                                               | (3.5)            | 758,300              | 9.71                           | (5.9)            |
| -200                                                          | 674,631           | 8.38                                               | (19.8)           | 600,547              | 7.79                           | (25.5)           |

Sterling does not manage its IRR by means of gap analysis. Instead, Sterling uses simulation modeling, which provides a more complete analysis than gap analysis, because gap analysis is simply an analytical tool designed to measure the difference between the amount of interest-earning assets and the amount of interest-bearing liabilities expected to mature or reprice in a given period. Gap analysis indicates theoretical repricing mismatches, but it does not consider basis differences that simulation modeling attempts to measure, such as differences due to yield curve shape, prepayment variability and other optionality. Gap analysis also does not consider assets or liabilities that have embedded options, a feature that allows early redemption. Cumulative gap positions are provided herein to indicate the general direction of the interest rate sensitivity of Sterling's assets and liabilities at the balance sheet dates indicated. A positive position indicates that assets maturing or repricing in a given period exceed maturing or repricing liabilities. A negative position indicates the opposite. An indication of a pricing match or mismatch does not necessarily indicate that income will change by any amount as the assets and liabilities may reprice to different indices, market rates for new products may vary and management may change discretionary pricing.

Sterling calculated its one-year cumulative gap position to be a negative 11.6% and a negative 10.4% at March 31, 2006 and December 31, 2005, respectively. Sterling calculated its three-year gap position to be a positive 0.4% and a negative 0.6% at March 31, 2006 and December 31, 2005, respectively. While the one-year cumulative gap shows liability sensitivity at March 31, 2006, it does not correlate directly to an increased exposure to rising interest rates. During the first quarter of 2006, Sterling's originations of fully floating construction loans were largely match funded with short-term CDs. Additionally, loan prepayment speeds for long-term loans can vary substantially in a rising rate environment. These effects are not considered when calculating traditional gap analysis. As a result of the aforementioned and ongoing balance sheet strategies, management believes that it has improved Sterling's IRR profile and will be able to better manage IRR.

Management attempts to maintain Sterling's gap position between positive 10% and negative 25%. At March 31, 2006 and December 31, 2005, Sterling's gap positions were within guidelines established by its Board of Directors.

Management is pursuing strategies to increase its NII without significantly increasing its cumulative gap positions in future periods. There can be no assurance that Sterling will be successful implementing these strategies or that, if these strategies are implemented, they will have the intended effect of increasing its NII. See Results of Operations *Net Interest Income* and *Capital*.

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### **Liquidity and Capital Resources**

As a financial institution, Sterling's primary sources of funds are investing and financing activities, including the collection of loan principal and interest payments. Financing activities consist primarily of customer deposits, advances from FHLB Seattle and other borrowings. Deposits increased 5.8% to \$5.09 billion at March 31, 2006 from \$4.81 billion at December 31, 2005, mainly due to increases of \$206.5 million and \$91.7 million, respectively, in time deposits and savings accounts. These increases reflected Sterling's use of these funds as a cost competitive source to generate loan growth.

Sterling Savings Bank actively manages its liquidity in an effort to maintain an adequate margin over the level necessary to support expected and potential loan fundings and deposit withdrawals. This is balanced with the need to maximize yield on alternative investments. The liquidity ratio may vary from time to time, depending on economic conditions, deposit fluctuations and loan funding needs.

During the three months ended March 31, 2006, net cash used in investing activities was \$322.7 million, which consisted mainly of loan funding, which was partially offset by cash inflows from loan principle paydowns and runoff in the MBS portfolio. During this period, net cash provided in financing activities was \$277.2 million, which consisted primarily of net inflows from deposit accounts.

Sterling Savings Bank's credit line with FHLB Seattle provides for borrowings up to a percentage of its total assets, subject to collateralization requirements. At March 31, 2006, this credit line represented a total borrowing capacity of \$2.64 billion, of which \$426.3 million was available. On March 31, 2006, the FHLB Seattle's Board of Directors voted to reduce the amount of stock that member banks must hold, allowing member banks to increase their borrowing capacity. The change became effective April 10, 2006. In May 2005, the FHLB Seattle began operating under a three year business and capital management plan. The plan includes dividend payment and stock repurchase restrictions. Sterling received no dividends during the three months ended March 31, 2006. In March 2006, the Federal Housing Finance Board (the Board) proposed amended regulations for the FHLB banks that would limit the amount of excess stock that FHLB banks could have outstanding and that would prescribe for them a minimum amount of retained earnings. The Board stated that it believed its proposed regulatory changes would reduce the risk that losses could deplete a FHLB's retained earnings and cause the impairment of the par value of an FHLB's stock.

Sterling Savings Bank also borrows funds under reverse repurchase agreements pursuant to which it sells investments (generally U.S. agency securities and MBS) under an agreement to buy them back at a specified price at a later date. These agreements to repurchase are deemed to be borrowings collateralized by the investments and MBS sold. Sterling Savings Bank uses these borrowings to supplement deposit gathering for funding the origination of loans. At March 31, 2006, Sterling Savings Bank had \$638.1 million in outstanding borrowings under reverse repurchase agreements and had securities available for additional secured borrowings of approximately \$215.3 million. The use of reverse repurchase agreements may expose Sterling to certain risks not associated with other borrowings, including IRR and the possibility that additional collateral may have to be provided if the market value of the pledged collateral declines.

Sterling, on a parent company-only basis, had cash of approximately \$18.8 million and \$15.7 million at March 31, 2006 and December 31, 2005, respectively. At March 31, 2006 and December 31, 2005, Sterling had an investment of \$110.1 million in the preferred stock of Sterling Savings Bank. At March 31, 2006 and December 31, 2005, Sterling had an investment in the common stock of Sterling Savings Bank of \$314.6 million and \$294.6 million, respectively. Sterling borrowed \$20.0 million from the Bank of Scotland during the three months ended March 31, 2006, and invested all of the proceeds into its common stock investment in Sterling Savings Bank. Sterling received cash dividends on Sterling Savings Bank preferred stock of \$2.9 million and common stock of \$2.0 million during the three months ended March 31, 2006. These resources contributed to Sterling's ability to meet its operating needs, including interest expense on its long-term debt. Sterling Savings Bank's ability to pay dividends is limited by its earnings, financial condition and capital requirements, as well as regulatory rules. See Note 2 of Notes to Consolidated Financial Statements.

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Sterling also has the ability to secure additional capital through the capital markets. The availability and cost of such capital is partially dependent on Sterling's credit ratings, which as of March 31, 2006 were as follows:

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

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

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

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

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

Rate locks and forward sales agreements on held-for-sale loans are considered to be derivatives. Sterling has recorded the estimated fair values of these rate locks and forward sales agreements on its balance sheet in either other assets or other liabilities. Changes in the fair values of these derivative instruments are recorded in income from mortgage banking operations in the income statement as the changes occur. The estimated fair value of rate locks and forward sales commitments were greater than the contracted amounts at March 31, 2006, which resulted in assets of \$48,000 and \$57,000, respectively. At December 31, 2005, rate locks and forward sales commitments were assets of \$147,000 and \$25,000, respectively.

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

Sterling's total shareholders' equity was \$508.7 million at March 31, 2006, compared to \$506.7 million at December 31, 2005. The increase in total shareholders' equity from the retention of earnings was mostly offset by the increase in the unrealized loss on the investment portfolio. Shareholders' equity was 6.5% of total assets at March 31, 2006 compared with 6.7% at December 31, 2005.

At March 31, 2006, Sterling had an unrealized loss of \$77.8 million on investment securities and MBS classified as available for sale. At December 31, 2005, Sterling had an unrealized loss of \$54.1 million on investment securities and MBS classified as available for sale. The change since December 31, 2005 reflected the decrease in the market value of the MBS portfolio, which was primarily caused by the increase in long-term interest rates compared to those at December 31, 2005. Fluctuations in prevailing interest rates continue to cause volatility in this component of accumulated comprehensive income or loss in shareholders' equity and may continue to do so in future periods.

Sterling has outstanding various series of capital securities ( Trust Preferred Securities ) issued to investors. The Trust Preferred Securities are treated as debt of Sterling, and qualify as Tier 1 capital, subject to certain limitations. For a complete description, see Note 2 of Notes to Consolidated Financial Statements.

Sterling and Sterling Savings Bank are required by applicable regulations to maintain certain minimum capital levels. Sterling and Sterling Savings Bank intend to enhance their capital resources and regulatory capital ratios through the retention of an adequate amount of earnings and the management of the level and mix of assets, although there can be no assurance in this regard. At March 31, 2006, Sterling and Sterling Savings Bank both exceeded all such regulatory capital requirements and were well capitalized pursuant to such regulations. The following table sets forth their respective capital positions at March 31, 2006:

|                                                   | Minimum Capital Requirements |       | Well-Capitalized Requirements |       | Actual     |       |
|---------------------------------------------------|------------------------------|-------|-------------------------------|-------|------------|-------|
|                                                   | Amount                       | Ratio | Amount                        | Ratio | Amount     | Ratio |
|                                                   | (Dollars in thousands)       |       |                               |       |            |       |
| Total capital to risk-weighted assets             |                              |       |                               |       |            |       |
| Sterling                                          | \$ 473,958                   | 8.0%  | \$ 592,448                    | 10.0% | \$ 600,737 | 10.1% |
| Sterling Savings Bank                             | 474,556                      | 8.0%  | 593,195                       | 10.0% | 599,147    | 10.1% |
| Tier 1 capital to risk-weighted assets            |                              |       |                               |       |            |       |
| Sterling                                          | 236,979                      | 4.0%  | 355,469                       | 6.0%  | 542,038    | 9.2%  |
| Sterling Savings Bank                             | 237,278                      | 4.0%  | 355,917                       | 6.0%  | 540,448    | 9.1%  |
| Tier 1 capital to average assets (leverage ratio) |                              |       |                               |       |            |       |
| Sterling                                          | 300,397                      | 4.0%  | 375,496                       | 5.0%  | 542,038    | 7.2%  |
| Sterling Savings Bank                             | 300,163                      | 4.0%  | 375,204                       | 5.0%  | 540,448    | 7.2%  |

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### **Goodwill Litigation**

In May 1990, Sterling sued the U.S. Government with respect to the loss of the goodwill treatment and other matters relating to Sterling's past acquisitions of three troubled thrift institutions during the 1980s (the Goodwill Litigation), seeking damages for, among other things, breach of contract. In September 2002, the U.S. Court of Federal Claims granted Sterling's motion for summary judgment as to liability on its contract claim, holding that the U.S. Government owed contractual obligations to Sterling and had breached its contracts with Sterling. On March 31, 2005, a hearing was held in the U.S. Court of Federal Claims on the U.S. Government's motion to reconsider part of the September 2002 liability judgment. Sterling opposed the motion. Sterling is waiting for a decision on the motion and for a trial date to be set to determine what amount, if any, the U.S. government must pay in damages for its breach. The timing and ultimate outcome of the Goodwill Litigation cannot be predicted with certainty.

### **New Accounting Policies**

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

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

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

### **Regulation and Compliance**

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

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**Forward-Looking Statements**

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

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

- inflation, interest rate levels and market and monetary fluctuations;
- trade, monetary and fiscal policies and laws, including interest rate policies of the federal government;
- applicable laws and regulations and legislative or regulatory changes;
- the timely development and acceptance of new products and services of Sterling;
- the willingness of customers to substitute competitors' products and services for Sterling's products and services;
- Sterling's success in gaining regulatory approvals, when required;
- technological and management changes;
- growth and acquisition strategies;
- Sterling's critical accounting policies and the implementation of such policies;
- lower-than-expected revenue or cost savings or other issues in connection with mergers and acquisitions;
- changes in consumer spending and saving habits;
- the strength of the United States economy in general and the strength of the local economies in which Sterling conducts its operations; and
- Sterling's success at managing the risks involved in the foregoing.

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**Item 3 Quantitative and Qualitative Disclosures About Market Risk**

For a discussion of Sterling's market risks, see Management's Discussion and Analysis Asset and Liability Management.

**Item 4 Controls and Procedures**

**Disclosure Controls and Procedures**

Sterling's management, with the participation of Sterling's principal executive officer and principal financial officer, has evaluated the effectiveness of Sterling's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of the end of the period covered by this report. Based on such evaluation, Sterling's principal executive officer and principal financial officer have concluded that, as of the end of such period, Sterling's disclosure controls and procedures are effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by Sterling in the reports that it files or submits under the Exchange Act.

**Changes in Internal Control Over Financial Reporting**

There were no changes in Sterling's internal control over financial reporting that occurred during the fiscal quarter to which this report relates that have materially affected, or are reasonably likely to materially affect, Sterling's internal control over financial reporting.

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

**Item 1 Legal Proceedings**

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

**Item 1a Risk Factors**

You should carefully consider the risks and uncertainties we describe both in this Report and in our Annual Report on Form 10-K for the fiscal year ended December 31, 2005, before deciding to invest in, or retain, shares of our common stock. These are not the only risks and uncertainties that we face. Additional risks and uncertainties that we do not currently know about or that we currently believe are immaterial, or that we have not predicted, may also harm our business operations or adversely affect us. If any of these risks or uncertainties actually occurs, our business, financial condition, operating results or liquidity could be materially harmed.

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

Not applicable.

**Item 3 Defaults Upon Senior Securities**

Not applicable.

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

Not applicable.

**Item 5 Other Information**

Not applicable.

**Item 6 Exhibits**

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

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**STERLING FINANCIAL CORPORATION**

**Signatures**

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

**STERLING FINANCIAL CORPORATION**

(Registrant)

May 9, 2006

By: /s/ Daniel G. Byrne

Date

**Daniel G. Byrne**

Executive Vice President, Assistant Secretary,  
and  
Chief Financial Officer

May 9, 2006

By: /s/ William R. Basom

Date

**William R. Basom**

Vice President, Treasurer, and Principal  
Accounting  
Officer

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**Exhibit Index**

**Exhibit No.**

- 3.1 Restated Articles of Incorporation of Sterling. Filed as Exhibit 4.1 to Sterling's registration statement on Form S-3 dated December 19, 2005 and incorporated by reference herein.
- 3.2 Articles of Amendment of Restated Articles of Incorporation of Sterling. Filed as Exhibit 4.2 to Sterling's registration statement on Form S-3 dated December 19, 2005 and incorporated by reference herein.
- 3.3 Amended and Restated Bylaws of Sterling. Filed as Exhibit 3.3 to Sterling's Registration Statement on Form S-4 filed December 9, 2002 and incorporated by reference herein.
- 4.1 Reference is made to Exhibits 3.1, 3.2 and 3.3.
- 4.2 Sterling has outstanding certain long-term debt. None of such debt exceeds ten percent of Sterling's total assets; therefore, copies of the constituent instruments defining the rights of the holders of such debt are not included as exhibits. Copies of instruments with respect to such long-term debt will be furnished to the Securities and Exchange Commission upon request.
- 31.1 Certification of Principal Executive Officer pursuant to Rule 13a-14(a) of the Exchange Act. Filed herewith.
- 31.2 Certification of Principal Financial Officer pursuant to Rule 13a-14(a) of the Exchange Act. Filed herewith.
- 32.1 Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350. Furnished herewith.
- 32.2 Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350. Furnished herewith.

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