STERLING FINANCIAL CORP /WA/
Form 10-Q
August 09, 2005

# UNITED STATES SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

# FORM 10-Q

**(Mark One)**

**x** **QUARTERLY REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**FOR THE QUARTERLY PERIOD ENDED June 30, 2005**

**OR**

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

**FOR THE TRANSITION PERIOD FROM TO .**

**Commission File Number 0-20800**

# STERLING FINANCIAL CORPORATION

(Exact name of registrant as specified in its charter)

| **Washington** | **91-1572822** |
|---|---|
| (State or other jurisdiction of incorporation or organization) | (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 x No ¨

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).
Yes x No ¨

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

| **Class** | **Outstanding as of July 29, 2005** |
|---|---|
| Common Stock ($1.00 par value) | 23,095,815 |

**STERLING FINANCIAL CORPORATION**

**FORM 10-Q**

**For the Quarter Ended June 30, 2005**

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**PART I - Financial Information**

**Item 1 - Financial Statements**

**STERLING FINANCIAL CORPORATION**

**Consolidated Balance Sheets**

**(Unaudited)**

| | June 30, 2005 | December 31, 2004 |
|---|---|---|
| | (Dollars in thousands) | |
| ASSETS: | | |
| Cash and cash equivalents: | | |
| Interest bearing | $ 11,000 | $ 0 |
| Non-interest bearing and vault | 111,849 | 93,187 |
| Restricted | 3,496 | 1,281 |
| Investment securities and mortgage-backed securities ( MBS ): | | |
| Available for sale | 1,996,804 | 2,157,136 |
| Held to maturity | 49,908 | 47,449 |
| Loans receivable, net | 4,181,265 | 4,251,877 |
| Loans held for sale | 15,559 | 14,224 |
| Accrued interest receivable | 28,664 | 27,479 |
| Real estate owned and other collateralized assets, net | 2,463 | 1,865 |
| Office properties and equipment, net | 80,582 | 78,402 |
| Bank-owned life insurance ( BOLI ) | 95,957 | 93,790 |
| Goodwill | 112,391 | 112,398 |
| Other intangible assets | 18,736 | 19,848 |
| Mortgage servicing rights, net | 6,381 | 4,078 |
| Prepaid expenses and other assets, net | 28,757 | 39,210 |
| Total assets | $ 6,743,812 | $ 6,942,224 |
| LIABILITIES: | | |
| Deposits | $ 4,200,196 | $ 3,863,296 |
| Advances from Federal Home Loan Bank Seattle ( FHLB Seattle ) | 1,317,141 | 1,635,933 |
| Securities sold subject to repurchase agreements and funds purchased | 536,152 | 780,012 |
| Other borrowings | 111,152 | 131,822 |
| Cashiers checks issued and payable | 11,585 | 3,213 |
| Borrowers reserves for taxes and insurance | 2,006 | 2,480 |
| Accrued interest payable | 16,699 | 14,842 |
| Accrued expenses and other liabilities | 45,394 | 40,782 |
| Total liabilities | 6,240,325 | 6,472,380 |
| Commitments and Contingencies | | |
| SHAREHOLDERS EQUITY: | | |
| Preferred stock, $1 par value; 10,000,000 shares authorized; no shares issued and outstanding | 0 | 0 |
| Common stock, $1 par value; 40,000,000 shares authorized; 23,084,300 and 22,936,154 shares issued and outstanding | 23,084 | 22,936 |
| Additional paid-in capital | 395,865 | 393,245 |
| Accumulated other comprehensive loss: | | |
| Unrealized losses on investment securities and MBS available-for-sale, net of deferred income taxes of $6,079 and $5,467 | (10,494) | (9,470) |
| Retained earnings | 95,032 | 63,133 |

| | | | | |
|---|---|---|---|---|
| Total shareholders equity | | 503,487 | | 469,844 |
| Total liabilities and shareholders equity | $ | 6,743,812 | $ | 6,942,224 |

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

**STERLING FINANCIAL CORPORATION**

**Consolidated Statements of Income**

**(Unaudited)**

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2005 | 2004 | 2005 | 2004 |
| | (Dollars in thousands, except per share data) | | | |
| Interest income: | | | | |
| Loans | $ 72,619 | $ 55,725 | $ 140,662 | $ 108,059 |
| MBS | 21,858 | 20,055 | 44,940 | 39,343 |
| Investments and cash equivalents | 579 | 1,460 | 1,520 | 3,229 |
| Total interest income | 95,056 | 77,240 | 187,122 | 150,631 |
| | | | | |
| Interest expense: | | | | |
| Deposits | 21,105 | 12,386 | 39,428 | 24,537 |
| Short-term borrowings | 7,391 | 4,877 | 16,365 | 8,711 |
| Long-term borrowings | 12,746 | 11,253 | 24,697 | 22,970 |
| Total interest expense | 41,242 | 28,516 | 80,490 | 56,218 |
| Net interest income | 53,814 | 48,724 | 106,632 | 94,413 |
| | | | | |
| Provision for losses on loans | (3,400) | (3,000) | (7,150) | (5,850) |
| Net interest income after provision for losses on loans | 50,414 | 45,724 | 99,482 | 88,563 |
| | | | | |
| Non-interest income: | | | | |
| Fees and service charges | 8,205 | 8,434 | 15,608 | 16,720 |
| Mortgage banking operations | 6,106 | 1,769 | 11,478 | 2,963 |
| Loan servicing fees | 103 | 160 | 240 | 306 |
| Net gains (losses) on sales of securities | 0 | 848 | (57) | 3,307 |
| Real estate owned and other collateralized assets operations | 99 | (341) | 211 | (316) |
| BOLI | 1,107 | 1,084 | 2,167 | 2,253 |
| Gain related to early repayment of debt | 0 | 0 | 645 | 0 |
| Other noninterest expense | (215) | (145) | (248) | (526) |
| | | | | |
| Total non-interest income | 15,405 | 11,809 | 30,044 | 24,707 |
| Non-interest expenses | 41,602 | 37,088 | 81,249 | 74,807 |
| Income before income taxes | 24,217 | 20,445 | 48,277 | 38,463 |
| Income tax provision | (8,209) | (6,962) | (16,378) | (12,996) |
| Net income | $ 16,008 | $ 13,483 | $ 31,899 | $ 25,467 |
| Earnings per share - basic | $ 0.69 | $ 0.60 | $ 1.39 | $ 1.13 |
| Earnings per share - diluted | $ 0.69 | $ 0.58 | $ 1.37 | $ 1.10 |
| Weighted average shares outstanding - basic | 23,065,309 | 22,589,109 | 23,027,803 | 22,471,725 |
| | | | | |
| Weighted average shares outstanding - diluted | 23,348,398 | 23,100,053 | 23,333,495 | 23,051,526 |

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

**STERLING FINANCIAL CORPORATION**

**Consolidated Statements of Cash Flows**

**(Unaudited)**

| | Six Months Ended June 30, | |
|---|---|---|
| | **2005** | **2004** |
| | **(Dollars in thousands)** | |
| Cash flows from operating activities: | | |
| Net income | $ 31,899 | $ 25,467 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provisions for losses on loans and real estate owned | 7,150 | 5,855 |
| Stock dividends on FHLB Seattle stock | (303) | (1,373) |
| Net gain on sales of loans, investment securities and MBS | (8,039) | (4,526) |
| Other gains and losses | (16,563) | 83 |
| Change in cash surrender value of BOLI | (2,167) | (2,253) |
| Depreciation and amortization | 9,133 | 7,475 |
| Change in: | | |
| Accrued interest receivable | (1,185) | (1,109) |
| Prepaid expenses and other assets | 9,018 | 4,143 |
| Cashiers checks issued and payable | 8,372 | 1,361 |
| Accrued interest payable | 1,857 | 1,304 |
| Accrued expenses and other liabilities | 3,112 | (7,542) |
| Proceeds from sales of loans originated for sale | 74,815 | 85,820 |
| Loans originated for sale | (73,175) | (84,601) |
| Net cash provided by operating activities | 43,924 | 30,104 |
| | | |
| Cash flows from investing activities: | | |
| Change in restricted cash | (2,215) | 201 |
| Loans funded and purchased | (1,556,810) | (1,304,323) |
| Loan principal received | 1,150,332 | 1,023,869 |
| Proceeds from sales of other loans | 472,682 | 0 |
| Purchase of investment securities | (5,764) | (229,460) |
| Proceeds from maturities of investment securities | 380 | 225,285 |
| Proceeds from sales of investment securities | 14,844 | 95,603 |
| Cash and cash equivalents acquired as part of mergers | 0 | 44,894 |
| Purchase of mortgage-backed securities | (153,188) | (710,378) |
| Principal payments on mortgage-backed securities | 181,294 | 188,378 |
| Proceeds from sales of mortgage-backed securities | 115,837 | 259,308 |
| Purchase of office properties and equipment | (6,414) | (5,996) |
| Sales of office properties and equipment | 249 | 0 |
| Improvements and other changes to real estate owned | (1,515) | 213 |
| Proceeds from sales and liquidation of real estate owned | 1,853 | 1,633 |
| Net cash provided (used) in investing activities | 211,565 | (410,773) |

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

| | Six Months Ended June 30, | |
|---|---|---|
| | 2005 | 2004 |
| | (Dollars in thousands) | |
| Cash flows from financing activities: | | |
| Net change in checking, regular savings and money market deposits | $ 69,473 | $ 97,568 |
| Proceeds from issuance of time deposits | 1,178,569 | 1,068,064 |
| Payments for maturing time deposits | (946,443) | (1,031,191) |
| Interest credited to deposits | 35,301 | 23,258 |
| Advances from FHLB Seattle | 425,229 | 518,464 |
| Repayment of advances from FHLB Seattle | (726,515) | (569,823) |
| Net change in securities sold subject to repurchase agreements and funds purchased | (243,860) | 296,125 |
| Repayment of other borrowings | (19,000) | (280) |
| Payments for fractional shares and certain merger costs | 0 | (240) |
| Proceeds from exercise of stock options, net of repurchases | 1,968 | 3,914 |
| Deferred financing costs | (75) | 0 |
| Other | (474) | 1,925 |
| Net cash provided (used) in financing activities | (225,827) | 407,784 |
| | | |
| Net change in cash and cash equivalents | 29,662 | 27,115 |
| Cash and cash equivalents, beginning of period | 93,187 | 65,479 |
| | | |
| Cash and cash equivalents, end of period | $ 122,849 | $ 92,594 |
| | | |
| Supplemental disclosures: | | |
| Cash paid during the period for: | | |
| Interest | $ 78,633 | $ 52,800 |
| Income taxes | 563 | 11,105 |
| | | |
| Noncash financing and investing activities: | | |
| Loans converted into real estate owned and other collateralized assets | 709 | 1,794 |
| Common stock issued upon business combination | 0 | 145,166 |

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

**STERLING FINANCIAL CORPORATION**

**Consolidated Statements of Comprehensive Income**

**(Unaudited)**

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2005 | 2004 | 2005 | 2004 |
| | (Dollars in thousands) | | | |
| Net income | $ 16,008 | $ 13,483 | $ 31,899 | $ 25,467 |
| Other comprehensive income: | | | | |
| Change in unrealized gains (losses) on investment securities and MBS available-for-sale | 24,820 | (55,670) | (1,636) | (24,845) |
| Less deferred income taxes | (9,180) | 19,485 | 612 | 8,696 |
| Net other comprehensive income (loss) | 15,640 | (36,185) | (1,024) | (16,149) |
| Comprehensive income (loss) | $ 31,648 | $ (22,702) | $ 30,875 | $ 9,318 |

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

**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, 2004. In the opinion of management, the unaudited interim consolidated financial statements furnished herein include all adjustments, all of which are of a normal recurring nature, necessary for a fair statement of the results for the interim periods presented.

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

## 2. Other Borrowings:

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

| | June 30, 2005 | December 31, 2004 |
|---|---|---|
| Term note payable(1) | $ 0 | $ 19,000 |
| Sterling obligated mandatorily redeemable preferred capital securities of subsidiary trusts holding solely junior subordinated deferrable interest debentures of Sterling(2) | 108,696 | 108,685 |
| Other(3) | 2,456 | 4,137 |
| Total | $ 111,152 | $ 131,822 |

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

On May 18, 2005, Sterling entered into a $40 million seven-year variable-rate revolving credit agreement (the Credit Facility ) with Bank of Scotland. Amounts loaned pursuant to the Credit Facility bear Eurodollar interest at the LIBOR rate (as defined in the Credit Facility) plus a

specified margin based on Sterling s credit ratings and compliance with the terms of the Credit Facility. The Credit Facility is secured by a portion 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 June 30, 2005, no funds had been advanced to Sterling under the Credit Facility. For further details, see Sterling s Form 8-K filed May 20, 2005 at the SEC s website, www.sec.gov.

(2) Sterling raises capital from time to time through the formation and acquisition of trusts (the Trusts ), which issue capital securities ( Trust Preferred Securities ) to investors. These 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 Trusts obligations under the Trust Preferred Securities. As of June 30, 2005, Sterling had seven such Trusts. The Trusts are not consolidated and the Trust Preferred Securities and common stock are treated as debt of Sterling. The common stock issued by the Trusts is recorded as other assets in the consolidated balance sheets, and totaled $3.3 million at June 30, 2005 and December 31, 2004. The Trust Preferred Securities have been structured to qualify as Tier 1 capital, subject to certain limitations. The Junior Subordinated Debentures and related Trust Preferred Securities are redeemable, under certain conditions, at Sterling s option. Interest is paid quarterly or semi-annually. Details of the Trusts, including the weighted average rate, are as follows:

| Subsidiary Issuer | Issue Date | Maturity Date | Call Date | Mandatorily Redeemable Capital Security | Rate Index | Contractual Rate at June 30, 2005 | Carrying Value (in thousands) |
|---|---|---|---|---|---|---|---|
| Sterling Capital Trust VI | June 2003 | Sept 2033 | Sept 2008 | Floating Rate Capital Securities | 3 month LIBOR plus 3.20% | 6.61 % | $ 10,310 |
| Sterling Capital Statutory Trust V | May 2003 | May 2033 | June 2008 | Floating Rate Capital Securities | 3 month LIBOR plus 3.25% | 6.72 % | 20,619 |
| Sterling Capital Trust IV | May 2003 | May 2033 | May 2008 | Floating Rate Preferred Securities | 3 month LIBOR plus 3.15% | 6.42 % | 10,310 |
| Sterling Capital Trust III | April 2003 | April 2033 | April 2008 | Floating Rate Capital Securities | 3 month LIBOR plus 3.25% | 6.46 % | 14,433 |
| Klamath First Capital Trust II | April 2002 | April 2032 | April 2007 | Floating Rate Capital Securities | 6 month LIBOR plus 3.70% | 7.11 % | 13,139 |
| Klamath First Capital Trust I | July 2001 | July 2031 | June 2006 | Floating Rate Capital Securities | 6 month LIBOR plus 3.75% | 6.71 % | 15,142 |
| Sterling Capital Trust II | July 2001 | July 2031 | June 2006 | 10.25% Cumulative Capital Securities | Fixed | 10.25 % | 24,743 |
| | | | | | | 7.50% | $ 108,696 |

(3) During 2002, Sterling financed the sale of certain loans to an unrelated party. Since the underlying loans served as collateral on the loan to the purchaser, this sale was accounted for as a financing. At June 30, 2005 and December 31, 2004, $2.5 million and $4.1 million, respectively, remained outstanding on the financing.

**3. Earnings Per Share:**

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

| | Three Months Ended June 30, | | | | | |
|---|---|---|---|---|---|---|
| | 2005 | | | 2004 | | |
| | Net Income | Weighted Avg. Shares | Per Share Amount | Net Income | Weighted Avg. Shares | Per Share Amount |
| Basic computations | $ 16,008,000 | 23,065,309 | $ 0.69 | $ 13,483,000 | 22,589,109 | $ 0.60 |
| Effect of dilutive securities: | | | | | | |
| Common stock options | 0 | 259,081 | 0.00 | 0 | 510,944 | (0.02) |
| Contingently issuable shares | 0 | 24,008 | 0.00 | 0 | 0 | 0.00 |
| Diluted computations | $ 16,008,000 | 23,348,398 | $ 0.69 | $ 13,483,000 | 23,100,053 | $ 0.58 |
| Antidilutive options not included in diluted earnings per share | | 304,000 | | | 11,000 | |

| | Six Months Ended June 30, | | | | | |
|---|---|---|---|---|---|---|
| | 2005 | | | 2004 | | |
| | Net Income | Weighted Avg. Shares | Per Share Amount | Net Income | Weighted Avg. Shares | Per Share Amount |
| Basic computations | $ 31,899,000 | 23,027,803 | $ 1.39 | $ 25,467,000 | 22,471,725 | $ 1.13 |
| Effect of dilutive securities: | | | | | | |
| Common stock options | 0 | 281,684 | (0.02) | 0 | 579,801 | (0.03) |
| Contingently issuable shares | 0 | 24,008 | 0.00 | 0 | 0 | 0.00 |
| Diluted computations | $ 31,899,000 | 23,333,495 | $ 1.37 | $ 25,467,000 | 23,051,526 | $ 1.10 |
| Antidilutive options not included in diluted earnings per share | | 304,000 | | | 11,000 | |

**4. Non-Interest Expenses:**

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2005 | 2004 | 2005 | 2004 |
| | (Dollars in thousands) | | | |
| Employee compensation and benefits | $ 22,334 | $ 19,118 | $ 44,351 | $ 38,324 |
| Occupancy and equipment | 6,617 | 5,929 | 12,663 | 11,147 |
| Depreciation | 2,106 | 1,785 | 4,121 | 3,523 |
| Amortization of core deposit intangibles | 555 | 555 | 1,111 | 1,111 |
| Advertising | 2,345 | 1,840 | 4,417 | 3,707 |
| Data processing | 3,037 | 2,826 | 6,212 | 4,899 |
| Insurance | 326 | 289 | 630 | 567 |
| Legal and accounting | 812 | 1,019 | 1,788 | 1,598 |
| Travel and entertainment | 1,225 | 1,073 | 2,182 | 1,936 |
| Goodwill litigation costs | 121 | 25 | 189 | 140 |
| Merger and acquisition costs | 0 | 922 | 0 | 4,835 |
| Other | 2,124 | 1,707 | 3,585 | 3,020 |
| | | | | |
| Total | $ 41,602 | $ 37,088 | $ 81,249 | $ 74,807 |

**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 Washington, Oregon, Idaho, Montana and Utah 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 Washington, Oregon, Arizona and California 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.

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 June 30, 2005 | | | | | |
|---|---|---|---|---|---|---|
| | Community Banking | Residential Mortgage Banking | Commercial Mortgage Banking | Retail Brokerage | Other and Eliminations | Total |
| | (Dollars in thousands) | | | | | |
| Interest income | $ 90,062 | $ 2,689 | $ 2,306 | $ 0 | $ (1) | $ 95,056 |
| Interest expense | (39,329) | 0 | 0 | 0 | (1,913) | (41,242) |
| Net interest income (expense) | 50,733 | 2,689 | 2,306 | 0 | (1,914) | 53,814 |
| Provision for loan losses | (3,400) | 0 | 0 | 0 | 0 | (3,400) |
| Noninterest income | 14,273 | 2,352 | 1,258 | 866 | (3,344) | 15,405 |
| Noninterest expense | (34,519) | (4,219) | (1,761) | (834) | (269) | (41,602) |
| Income before income taxes | $ 27,087 | $ 822 | $ 1,803 | $ 32 | $ (5,527) | $ 24,217 |
| Total assets | $ 6,807,155 | $ 19,697 | $ 19,288 | $ 763 | $ (103,091) | $ 6,743,812 |

| | As of and for the Three Months Ended June 30, 2004 | | | | | |
|---|---|---|---|---|---|---|
| | Community Banking | Residential Mortgage Banking | Commercial Mortgage Banking | Retail Brokerage | Other and Eliminations | Total |
| | (Dollars in thousands) | | | | | |
| Interest income | $ 73,094 | $ 2,253 | $ 1,666 | $ 0 | $ 227 | $ 77,240 |
| Interest expense | (26,521) | 0 | 0 | 0 | (1,995) | (28,516) |
| Net interest income (expense) | 46,573 | 2,253 | 1,666 | 0 | (1,768) | 48,724 |
| Provision for loan losses | (3,000) | 0 | 0 | 0 | 0 | (3,000) |
| Noninterest income | 11,536 | 2,063 | 831 | 903 | (3,524) | 11,809 |
| Noninterest expense | (31,874) | (3,448) | (1,002) | (721) | (43) | (37,088) |
| Income before income taxes | $ 23,235 | $ 868 | $ 1,495 | $ 182 | $ (5,335) | $ 20,445 |
| Total assets | $ 6,295,133 | $ 18,488 | $ 16,111 | $ 1,345 | $ (71,966) | $ 6,259,111 |

| | As of and for the Six Months Ended June 30, 2005 | | | | | |
|---|---|---|---|---|---|---|
| | Community Banking | Residential Mortgage Banking | Commercial Mortgage Banking | Retail Brokerage | Other and Eliminations | Total |
| | (Dollars in thousands) | | | | | |
| Interest income | $ 177,918 | $ 5,108 | $ 4,097 | $ 0 | $ (1) | $ 187,122 |
| Interest expense | (76,627) | 0 | 0 | 0 | (3,863) | (80,490) |
| Net interest income (expense) | 101,291 | 5,108 | 4,097 | 0 | (3,864) | 106,632 |
| Provision for loan losses | (7,150) | 0 | 0 | 0 | 0 | (7,150) |
| Noninterest income | 27,923 | 4,581 | 2,689 | 1,671 | (6,820) | 30,044 |
| Noninterest expense | (68,107) | (8,384) | (3,126) | (1,624) | (8) | (81,249) |
| Income before income taxes | $ 53,957 | $ 1,305 | $ 3,660 | $ 47 | $ (10,692) | $ 48,277 |
| Total assets | $ 6,807,155 | $ 19,697 | $ 19,288 | $ 763 | $ (103,091) | $ 6,743,812 |

| | As of and for the Six Months Ended June 30, 2004 | | | | | |
|---|---|---|---|---|---|---|
| | Community Banking | Residential Mortgage Banking | Commercial Mortgage Banking | Retail Brokerage | Other and Eliminations | Total |
| | (Dollars in thousands) | | | | | |
| Interest income | $ 142,483 | $ 4,282 | $ 3,413 | $ 1 | $ 452 | $ 150,631 |
| Interest expense | (52,227) | 0 | 0 | 0 | (3,991) | (56,218) |
| Net interest income (expense) | 90,256 | 4,282 | 3,413 | 1 | (3,539) | 94,413 |
| Provision for loan losses | (5,850) | 0 | 0 | 0 | 0 | (5,850) |
| Noninterest income | 23,744 | 3,847 | 1,214 | 1,859 | (5,957) | 24,707 |
| Noninterest expense | (64,252) | (6,633) | (2,157) | (1,471) | (294) | (74,807) |
| Income before income taxes | $ 43,898 | $ 1,496 | $ 2,470 | $ 389 | $ (9,790) | $ 38,463 |
| Total assets | $ 6,295,133 | $ 18,488 | $ 16,111 | $ 1,345 | $ (71,966) | $ 6,259,111 |

**6. Stock Options:**

As permitted by Financial Accounting Standards Board ( FASB ) Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation ( SFAS No. 123 ), Sterling elected to retain the compensation measurement principles of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees ( APB No. 25 ), and related interpretations, for stock options. Under APB No. 25, compensation cost is recognized at the measurement date in the amount, if any, that the quoted market price of Sterling s common stock exceeds the option exercise price. Sterling grants its common stock options to employees with exercise prices equal to the market price of Sterling s common stock on the measurement date. Thus, no compensation cost is recognized.

Sterling has chosen not to record compensation expense using fair value measurement provisions in the statement of income. See New Accounting Policies for guidance on the effect of the FASB s revision of SFAS No. 123. Had compensation cost for Sterling s plans been determined based on the fair value at the grant dates for awards under the plans, Sterling s reported net income and earnings per share would have been changed to the pro forma amounts indicated below:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2005 | 2004 | 2005 | 2004 |
| | (Dollars in thousands, except per share amounts) | | | |
| Reported net income | $ 16,008 | $ 13,483 | $ 31,899 | $ 25,467 |
| Add back: Stock-based employee compensation expense, net of related tax effects | 0 | 0 | 0 | 0 |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | (19) | (1,009) | (54) | (2,018) |
| Pro forma | $ 15,989 | $ 12,474 | $ 31,845 | $ 23,449 |
| | | | | |
| Basic earnings per share: | | | | |
| Reported earnings per share | $ 0.69 | $ 0.60 | $ 1.39 | $ 1.13 |
| Stock-based employee compensation, fair value | 0.00 | (0.05) | (0.01) | (0.09) |
| Pro forma earnings per share | $ 0.69 | $ 0.55 | $ 1.38 | $ 1.04 |
| | | | | |
| Diluted earnings per share: | | | | |
| Reported earnings per share | $ 0.69 | $ 0.58 | $ 1.37 | $ 1.10 |
| Stock-based employee compensation, fair value | (0.01) | (0.04) | (0.01) | (0.08) |
| Pro forma earnings per share | $ 0.68 | $ 0.54 | $ 1.36 | $ 1.02 |

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

| | Six Months Ended June 30, | |
|---|---|---|
| | 2005(1) | 2004 |
| Expected volatility | N/A | 85% - 132% |
| Expected lives (in years) | N/A | 4 - 10 |
| Risk free interest rates | N/A | 2.86% - 6.52% |
| Expected forfeiture rate | N/A | 0% |
| Annual dividend yield | N/A | 0% |

(1) In 2005, no stock options have been issued.

**7. New Accounting Policies:**

In December 2004, the FASB issued SFAS No. 123 (revised 2004), Share-Based Payment, which established accounting standards for transactions involving the issuance of equity instruments to employees for services rendered. This statement is a revision of SFAS No. 123, and supersedes APB No. 25. This statement requires the estimation and recognition of the grant date fair value of stock options issued to employees. This statement is effective for Sterling as of January 1, 2006. Management is currently evaluating the effect of this new standard.

In September 2004, the FASB agreed to issue additional guidance on the application of Emerging Issues Task Force ( EITF ) Issue 03-1, The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments. The FASB also deferred the measurement and recognition guidance contained in EITF Issue 03-1. In June 2005, the FASB revised EITF Issue 03-1 by deleting the requirement for investors to demonstrate the ability and intent to hold securities until recovery of impairment. Sterling will continue to apply relevant other-than-temporary guidance to its investment securities and MBS portfolio, as applicable.

In December 2003, the American Institute of Certified Public Accountants issued Statement of Position No. 03-3, Accounting for Certain Loans or Debt Securities Acquired in a Transfer ( SOP No. 03-3 ). SOP No. 03-3 addresses accounting for differences between contractual cash flows and cash flows expected to be collected from an investor s initial investment in loans acquired in a transfer if those differences are attributable, at least in part, to credit quality. SOP No. 03-3 is effective for loans acquired in fiscal years beginning after December 15, 2004. The implementation of SOP No. 03-3 did not have a material effect on Sterling s consolidated financial statements.

**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, especially in rising interest rate environments.

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 June 30, 2005, which resulted in assets of $295,000 and $64,000, respectively. At December 31, 2004, rate locks and forward sales commitments were assets of $76,000 and $12,000, respectively.

**9. Subsequent Events:**

On July 8, 2005, Sterling announced that it had received regulatory approval from the Washington State Department of Financial Institutions to convert Sterling Savings Bank, its wholly-owned subsidiary, from a state-chartered savings and loan association to a state-chartered commercial bank. Sterling also announced that the approval from the Federal Reserve Board to convert Sterling from a savings and loan holding company to a bank holding company had been received. The charter conversion was effective as of July 8, 2005.

On July 26, 2005, Sterling announced a 3 for 2 stock split, payable on August 31, 2005 to shareholders of record on August 17, 2005. This split will be effected in the form of a 50% stock dividend. Sterling also announced a quarterly cash dividend of $0.05 per common share, payable on October 14, 2005 to shareholders of record as of September 30, 2005.

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

**STERLING FINANCIAL CORPORATION**

**Comparison of the Three and Six Months Ended June 30, 2005 and 2004**

*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 2004 annual report on Form 10-K.*

**General**

As of June 30, 2005, Sterling Financial Corporation ( Sterling ) was a unitary savings and loan holding company, the significant operating subsidiary of which was Sterling Savings Bank. Effective July 8, 2005, Sterling converted to a Bank Holding Company and Sterling Savings Bank converted to a Washington State chartered commercial bank. See Note 9 of Notes to Consolidated Financial Statements. 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.

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 Pacific Northwest region. With $6.74 billion in total assets at June 30, 2005, Sterling originates loans and attracts Federal Deposit Insurance Corporation ( FDIC ) insured deposits from the general public through 137 financial service centers located in Washington, Oregon, Idaho and Montana. Sterling also originates loans through Action Mortgage residential loan production offices in the four-state area, as well as Utah, and through INTERVEST commercial real estate lending offices in Washington, Oregon, Arizona and California. Sterling also markets fixed income and equity products, mutual funds, fixed and variable annuities and many other financial products through Harbor Financial service representatives located throughout Sterling s financial service center network.

Sterling continues to implement its strategy to become the leading community bank in the Pacific Northwest by increasing its commercial real estate, business banking, consumer and construction lending while also increasing its retail deposits, particularly transaction accounts. Commercial real estate, business banking, consumer and construction loans generally produce higher yields than residential loans. Management believes that a community bank mix of assets and liabilities will enhance its net interest income ( NII ) (the difference between the interest earned on loans and investments and the interest paid on deposits and borrowings) and will increase other fee income, although there can be no assurance in this regard. Such loans, however, generally involve a higher degree of risk than financing residential real estate. Sterling s revenues are derived primarily from interest earned on loans and mortgage-backed securities ( MBS ), fees and service charges, and mortgage banking operations ( MBO ). During the period ended June 30, 2005, the operations of Sterling Savings Bank and savings institutions generally, were influenced significantly by general economic conditions and by policies of its primary regulatory authorities, the Office of Thrift Supervision ( OTS ), the FDIC and the Washington State Department of Financial Institutions ( Washington Supervisor ).

**Executive Summary and Highlights**

Sterling s earnings of $16.0 million, or $0.69 per diluted share, for the second quarter of 2005 represented a 19% increase over earnings of $13.5 million, or $0.58 per diluted share, for the prior year s comparable quarter. For the six months ended June 30, 2005, Sterling recorded earnings of $31.9 million, or $1.37 per diluted share, a 25% increase over earnings of $25.5 million or $1.10 per diluted share for the prior year s comparable six month period.

NII of $53.8 million and $106.6 million represented a 10% and 13% increase over the respective 2004 amounts, primarily due to increased average loan and MBS volumes. Sterling s net interest margin for the three and six months ended June 30, 2005 decreased by 14 and 12 basis points, respectively, from the comparable 2004 periods. The compression in net interest margin over the prior year periods can be attributed to a greater increase in the cost of deposits versus the yield on loans, and a decrease in income resulting from the Federal Home Loan Bank Seattle s suspension of its dividends.

MBO income increased to $6.1 million for the June 30, 2005 quarter, up from $1.8 million for the same period in 2004. Sterling sold nearly $403 million in residential permanent and commercial real estate loans in the quarter, compared to just over $57.3 million in the June 2004 quarter. For the six months ended June 30, 2005, MBO income increased to $11.5 million from $3.0 million for the same period in 2004, as a result of increased loan sales.

Sterling s loan originations for the quarter ended June 30, 2005 were $908.1 million, compared with $786.4 million in the second quarter of 2004, a 15% increase. The growth occurred in construction, residential and business lending. Sterling s loan originations for the six months ended June 30, 2005 were $1.73 billion, compared with $1.38 billion for same period in 2004, an increase of 26%.

**Highlights for the second quarter of 2005 were as follows:**

Earnings per diluted share were $0.69 for the quarter ended June 30, 2005, compared to $0.58 per diluted share for the quarter ended June 30, 2004, a 19% increase.

Deposits increased to $4.20 billion, up $599.6 million, or 17%, year-over-year.

Return on average equity was 13.4% for the quarter ended June 30, 2005.

Return on average assets was 0.92% for the quarter ended June 30, 2005.

Equity to assets ratio was 7.47% at June 30, 2005.

Loan production for the quarter was $908.1 million, up 15% over the June 2004 quarter.

Construction lending nearly doubled over the prior year to $424.5 million for the quarter ended June 30, 2005.

**Company Growth**

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

**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.

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 June 30, 2005.

***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. There were no investment securities that management identified to be other-than-temporarily impaired during the three months ended June 30, 2005, because the decline in fair value was attributable to changes in interest rates and not credit quality, and because Sterling has the ability and intent to hold these investments until a recovery in market price occurs, or until maturity. Realized losses could occur in future periods due to a change in management s intent to hold the investments to maturity, a change in management s assessment of credit risk, or a change in regulatory or accounting requirements.

***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 assets for impairment in value whenever events or circumstances indicate that the carrying value of the property or other assets may not be recoverable. In performing the review, if expected future undiscounted cash flow from the use of the property or other assets, or the fair value, less selling costs, from the disposition of the property or other assets is less than its carrying value, an impairment loss is recognized.

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

Sterling uses an estimate of future earnings to support its position that the benefit of its net deferred 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 $16.0 million, or $0.69 per diluted share, for the three months ended June 30, 2005, compared with net income of $13.5 million, or $0.58 per diluted share, for the three months ended June 30, 2004. Net income for the six months ended June 30, 2005 was $31.9 million, or $1.37 per diluted share compared with net income of $25.5 million, or $1.10 per diluted share for the six months ended June 30, 2004. The increases in net income for both periods reflect an increase in NII and non-interest income.

The annualized return on average assets ( ROA ) was 0.92% and 0.86% for the three months ended June 30, 2005 and 2004, respectively, and 0.92% and 0.84% for the six months ended June 30, 2005 and 2004, respectively. The annualized return on average equity ( ROE ) was 13.4% and 12.4% for the three months ended June 30, 2005 and

2004, respectively, and 13.5% and 12.2% for the six months ended June 30, 2005 and 2004, respectively. The increase in ROA and ROE over the 2004 periods was primarily due to increases in NII and MBO 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 June 30, 2005 and 2004, NII was $53.8 million and $48.7 million, respectively, an increase of 10%. During the six months ended June 30, 2005 and 2004, NII was $106.6 million and $94.4 million, respectively, an increase of 13%. The increase in NII during the 2005 periods compared to the 2004 periods was primarily due to the increases in average loan and MBS 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 June 30, 2005 vs. 2004 Increase (Decrease) Due to: | | | | Six months ended June 30, 2005 vs. 2004 Increase (Decrease) Due to: | | | |
|---|---|---|---|---|---|---|---|---|
| | Volume | Rate | Rate/ Volume | Total | Volume | Rate | Rate/ Volume | Total |
| | (Dollars in thousands) | | | | | | | |
| Rate/volume analysis: | | | | | | | | |
| Interest income: | | | | | | | | |
| Loans | $ 11,565 | $ 4,288 | $ 1,041 | $ 16,894 | $ 24,375 | $ 6,955 | $ 1,273 | $ 32,603 |
| MBS | 929 | 783 | 91 | 1,803 | 4,700 | 899 | (2) | 5,597 |
| Investments and cash equivalents | (93) | (846) | 58 | (881) | (683) | (1,291) | 265 | (1,709) |
| Total interest income | 12,401 | 4,225 | 1,190 | 17,816 | 28,392 | 6,563 | 1,536 | 36,491 |
| Interest expense: | | | | | | | | |
| Deposits | 2,019 | 5,734 | 966 | 8,719 | 4,020 | 9,395 | 1,476 | 14,891 |
| Advances from FHLB Seattle | 395 | 296 | 41 | 732 | 2,237 | 995 | 41 | 3,273 |
| All other borrowings | 966 | 1,934 | 375 | 3,275 | 2,821 | 2,571 | 716 | 6,108 |
| Total interest expense | 3,380 | 7,964 | 1,382 | 12,726 | 9,078 | 12,961 | 2,233 | 24,272 |
| Net changes in NII | $ 9,021 | $ (3,739) | $ (192) | $ 5,090 | $ 19,314 | $ (6,398) | $ (697) | $ 12,219 |

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

| Three Months Ended | Net Interest Margin |
|---|---|
| June 30, 2005 | 3.26% |
| March 31, 2005 | 3.22% |
| December 31, 2004 | 3.25% |
| September 30, 2004 | 3.31% |
| June 30, 2004 | 3.40% |

Average interest-earning assets for the three months ended June 30, 2005 and 2004 were $6.62 billion and $5.77 billion, respectively. Average loans increased by $776.2 million, while average investment securities and MBS increased by $74.4 million over the 2004 amounts. Net interest spread during these periods was 3.21% and 3.37%, respectively. Net interest margin for the three months ended June 30, 2005 and 2004 was 3.26% and 3.40%, respectively. The decrease in these ratios during the three and six months ended June 30, 2005, compared to the same periods in 2004, reflected the impact of the continued flattening of the yield curve on Sterling s interest-earning assets and interest-bearing liabilities. Sterling experienced some lag in the repricing of certain variable-rate loans. As a result, the yields on loans and investments increased from the preceding periods, but at a slower pace than Sterling s interest-bearing liabilities.

***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 $3.4 million and $3.0 million for the three months ended June 30, 2005 and 2004, respectively. The current provision reflects the analysis and assessment of the relevant factors mentioned in the preceding paragraph. Management anticipates that its provisions for losses on loans will continue to increase, reflecting Sterling s strategic direction of originating more commercial real estate, construction, business banking and consumer loans 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:

| | Six Months Ended June 30, | |
|---|---|---|
| | 2005 | 2004 |
| | (Dollars in thousands) | |
| Balance at January 1 | $ 49,362 | $ 35,605 |
| Allowance for loan losses acquired | 0 | 6,722 |
| Provision for losses on loans | 7,150 | 5,850 |
| Amounts written off net of recoveries and other | (1,919) | (2,926) |
| Balance at June 30 | $ 54,593 | $ 45,251 |

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At June 30, 2005, Sterling s total classified assets were 1.09% of total assets, compared with 0.98% of total assets at December 31, 2004 and 1.29% of total assets at June 30, 2004. Nonperforming assets were 0.26% of total assets at June 30, 2005, compared with 0.20% of total assets at December 31, 2004 and 0.27% of total assets at June 30, 2004. Sterling does not anticipate significant losses in these classified assets, although there can be no assurances in this regard. At June 30, 2005, the loan delinquency ratio was 0.45% of total loans compared to 0.32% at December 31, 2004 and 0.43% of total loans at June 30, 2004. 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 June 30, | | | Six Months Ended June 30, | | |
|---|---|---|---|---|---|---|
| | 2005 | 2004 | % Change | 2005 | 2004 | % Change |
| | (Dollars in thousands) | | | | | |
| Fees and service charges | $ 8,205 | $ 8,434 | (2.7) | $ 15,608 | $ 16,720 | (6.7) |
| Mortgage banking operations | 6,106 | 1,769 | 245.2 | 11,478 | 2,963 | 287.4 |
| Loan servicing fees | 103 | 160 | (35.6) | 240 | 306 | (21.6) |
| Net gains (losses) on sales of securities | 0 | 848 | (100.0) | (57) | 3,307 | (101.7) |
| Real estate owned operations | 99 | (341) | (129.0) | 211 | (316) | (166.8) |
| BOLI | 1,107 | 1,084 | 2.1 | 2,167 | 2,253 | (3.8) |
| Gain on early estinguishment of debt | 0 | 0 | 0.0 | 645 | 0 | 100.0 |
| Other non-interest expense | (215) | (145) | 48.3 | (248) | (526) | (52.9) |
| Total | $ 15,405 | $ 11,809 | 30.5 | $ 30,044 | $ 24,707 | 21.6 |

The increase in non-interest income was primarily due to an increase in income from MBO. The increase reflected $402.8 million of residential and commercial real estate loan sales during the second quarter of 2005 versus $57.3 million of such sales in the comparative 2004 period. The increase in sales during the quarter reflected the execution of Sterling s business plan, allowing it to take advantage of opportunities in the market, as well as loan portfolio adjustments in anticipation of Sterling Savings Bank s conversion to a commercial bank charter.

During the quarter ended June 30, 2005, Sterling did not sell any investment securities or MBS, compared with $77.4 million for the quarter ended June 30, 2004. During the second quarter of 2004, Sterling recognized a net gain of $0.8 million on sales of investment securities and MBS. There were no sales during the June 2005 quarter as a result of management s response to market conditions and portfolio management needs.

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2005 | 2004 | 2005 | 2004 |
| | (Dollars in millions) | | | |
| Originations of one- to four-family permanent mortgage loans | $ 106.5 | $ 91.9 | $ 263.0 | $ 162.7 |
| Sales of residential loans | 315.2 | 55.0 | 451.5 | 82.3 |
| Sales of commercial real estate loans | 87.6 | 2.3 | 120.0 | 2.3 |
| Principal balances of residential loans serviced for others | 674.9 | 206.3 | 674.9 | 206.3 |
| Principal balances of commercial real estate loans serviced for others | 719.7 | 291.0 | 719.7 | 291.0 |

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

| | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|---|---|---|---|---|---|---|
| | 2005 | 2004 | % Change | 2005 | 2004 | % Change |
| | (Dollars in thousands) | | | | | |
| Employee compensation and benefits | $ 22,334 | $ 19,118 | 16.8 | $ 44,351 | $ 38,324 | 15.7 |
| Occupancy and equipment | 6,617 | 5,929 | 11.6 | 12,663 | 11,147 | 13.6 |
| Depreciation | 2,106 | 1,785 | 18.0 | 4,121 | 3,523 | 17.0 |
| Amortization of core deposit intangibles | 555 | 555 | 0.0 | 1,111 | 1,111 | 0.0 |
| Advertising | 2,345 | 1,840 | 27.4 | 4,417 | 3,707 | 19.2 |
| Data processing | 3,037 | 2,826 | 7.5 | 6,212 | 4,899 | 26.8 |
| Insurance | 326 | 289 | 12.8 | 630 | 567 | 11.1 |
| Legal and accounting | 812 | 1,019 | (20.3) | 1,788 | 1,598 | 11.9 |
| Travel and entertainment | 1,225 | 1,073 | 14.2 | 2,182 | 1,936 | 12.7 |
| Goodwill litigation costs | 121 | 25 | 386.0 | 189 | 140 | 35.4 |
| Merger and acquisition costs | 0 | 922 | (100.0) | 0 | 4,835 | (100.0) |
| Other | 2,124 | 1,707 | 24.4 | 3,585 | 3,020 | 18.7 |
| Total | $ 41,602 | $ 37,088 | 12.2 | $ 81,249 | $ 74,807 | 8.6 |

The three and six month increases in non-interest expenses was mostly due to growth in the scale of operations, and reflect higher personnel, occupancy and advertising expenses. Full-time equivalent employees increased year-over-year by 155 to 1,707 at June 30, 2005.

***Income Tax Provision***. Sterling recorded federal and state income tax provisions of $8.2 million and $7.0 million for the three months ended June 30, 2005 and 2004, respectively, and $16.4 million and $13.0 million for the six months ended June 30, 2005 and 2004, respectively. The effective tax rates for the three month comparative periods were 33.9% and 34.1%, respectively, and 33.9% and 33.8%, respectively, for the six month comparative periods.

**Financial Position**

***Assets***. At June 30, 2005, Sterling s assets were $6.74 billion, down $198.4 million from $6.94 billion at December 31, 2004, mainly reflecting loan sales totaling $571.5 million during the period, as Sterling continued repositioning its portfolio towards a mix of products typical for a commercial bank, and taking advantage of opportunities in the MBO market. Funds received on the loan sales were mainly used to pay down wholesale borrowings.

***Investment Securities and MBS***. Sterling s investment and MBS portfolio at June 30, 2005 was $2.05 billion, a decrease of $157.9 million from the December 31, 2004 balance of $2.20 billion. The decrease was mainly due to principal repayments and maturities.

***Loans Receivable***. At June 30, 2005, net loans receivable were $4.18 billion, down $70.6 million from $4.25 billion at December 31, 2004. The decrease was due to loan sales during the period, net of new originations. Sterling anticipates further loan sales during the second half of 2005, and funding on originations to outpace the MBO activity.

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 or allowances for loan losses:

| | June 30, 2005 | | December 31, 2004 | |
|---|---|---|---|---|
| | Amount | % | Amount | % |
| | (Dollars in thousands) | | | |
| Residential real estate | $ 495,682 | 11.7 | $ 794,632 | 18.4 |
| Multifamily real estate | 225,476 | 5.3 | 184,754 | 4.3 |
| Commercial real estate | 568,945 | 13.4 | 699,879 | 16.3 |
| Real estate construction | 801,746 | 18.9 | 652,895 | 15.2 |
| Consumer - direct | 591,409 | 13.9 | 543,895 | 12.6 |
| Consumer - indirect | 128,510 | 3.0 | 120,894 | 2.8 |
| Business and private banking | 994,054 | 23.4 | 932,146 | 21.6 |
| Corporate banking | 438,038 | 10.4 | 379,051 | 8.8 |
| Gross loans receivable | 4,243,860 | 100.0 | 4,308,146 | 100.0 |
| Net deferred origination fees | (8,002) | | (6,907) | |
| Allowance for losses on loans | (54,593) | | (49,362) | |
| Loans receivable, net | $ 4,181,265 | | $ 4,251,877 | |

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

| | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|---|---|---|---|---|---|---|
| | 2005 | 2004 | % Change | 2005 | 2004 | % Change |
| | (Dollars in thousands) | | | | | |
| Residential real estate | $ 106,489 | $ 91,948 | 15.8 | $ 262,972 | $ 162,677 | 61.7 |
| Multifamily real estate | 0 | 21,080 | (100.0) | 13,267 | 36,417 | (63.6) |
| Commercial real estate | 14,700 | 37,755 | (61.1) | 69,755 | 98,515 | (29.2) |
| Real estate construction | 424,519 | 213,079 | 99.2 | 769,439 | 388,591 | 98.0 |
| Consumer - direct | 120,593 | 127,792 | (5.6) | 184,544 | 195,924 | (5.8) |
| Consumer - indirect | 21,746 | 11,512 | 88.9 | 36,788 | 24,419 | 50.7 |
| Business and private banking | 130,128 | 122,621 | 6.1 | 224,276 | 265,974 | (15.7) |
| Corporate banking | 89,955 | 160,576 | (44.0) | 169,688 | 203,816 | (16.7) |
| Total loans originated | $ 908,130 | $ 786,363 | 15.5 | $ 1,730,729 | $ 1,376,333 | 25.7 |

***Deposits***. Total deposits increased to $4.20 billion at June 30, 2005 from $3.86 billion at December 31, 2004. The deposit growth principally reflected increases in time deposits and transaction accounts of $257.6 million and $68.1 million, respectively. The growth in time deposits reflects, in part, the increase in interest rates as customers began shifting funds to higher yielding deposit products. The growth in checking accounts during the quarter in part reflects deposits from the two financial service centers opened this year. Sterling has also added several new business and corporate lending teams throughout the region that have generated additional loan originations and increased deposit growth.

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

| | June 30, 2005 | | December 31, 2004 | |
|---|---|---|---|---|
| | Amount | % | Amount | % |
| | (Dollars in thousands) | | | |
| NOW checking | $ 420,460 | 10.0 | $ 413,217 | 10.7 |
| Noninterest-bearing checking | 634,997 | 15.1 | 574,186 | 14.9 |
| Savings and MMDA | 1,116,071 | 26.6 | 1,104,871 | 28.6 |
| Time deposits | 2,028,668 | 48.3 | 1,771,022 | 45.8 |
| Total deposits | $ 4,200,196 | 100.0 | $ 3,863,296 | 100.0 |

***Borrowings***. Deposit accounts are Sterling s primary source of funds. Sterling does, however, rely upon advances from the Federal Home Loan Bank Seattle ( FHLB Seattle ), reverse repurchase agreements and other borrowings to supplement its funding and to meet deposit withdrawal requirements. At June 30, 2005, the total of such borrowings was $1.96 billion compared with $2.55 billion at December 31, 2004. During the first quarter of 2005, Sterling prepaid $258.0 million of FHLB Seattle advances, resulting in a net gain on the extinguishment of debt of $645,000. Other borrowings decreased from December 31, 2004, as Sterling paid off its term note to U.S. Bank. See Liquidity and Capital Resources.

**Asset and Liability Management**

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

Additionally, the extent to which borrowers prepay loans is affected by prevailing interest rates. When interest rates increase, borrowers are less likely to prepay loans; whereas, when interest rates decrease, borrowers are more likely to prepay loans. Prepayments may affect the levels of loans retained in an institution s portfolio, as well as its NII.

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

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

identical terms.

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

Sterling is continuing to pursue strategies to manage the level of its IRR while increasing its NII and NPV: a) through the origination and retention of variable-rate consumer, business banking, construction and commercial real estate loans, which generally have higher yields than residential permanent loans; b) by the sale of certain long-term fixed-rate loans and investments; and c) by increasing the level of its core deposits, which are generally a lower-cost funding source than wholesale borrowings. There can be no assurance that Sterling will be successful implementing any of these strategies or that, if these strategies are implemented, they will have the intended effect of reducing IRR or increasing NII and NPV.

The following table indicates the sensitivity of Sterling s NII for the periods indicated and for meaningful changes in interest rates. Projections assuming large interest rate decreases in a low interest rate environment are not included because they would not result in a meaningful calculation. 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 Interest Rate in Basis Points (Rate Shock) | June 30, 2005 % Change in NII | December 31, 2004 % Change in NII |
|---|---|---|
| +300 | (9.2) | 1.1 |
| +200 | (5.4) | 1.4 |
| +100 | (1.4) | 0.0 |
| Static | 0.0 | 0.0 |
| -100 | (1.5) | 0.3 |
| -200 | (5.4) | (4.8) |

The following table presents Sterling s estimates of changes in NPV for the periods indicated and for meaningful changes in interest rates. Projections assuming large interest rate decreases in a low interest rate environment are not included because they would not result in a meaningful calculation. 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 Interest Rate in Basis Points (Rate Shock) | At June 30, 2005 NPV | At June 30, 2005 Ratio of NPV to the Present Value of Total Assets | At June 30, 2005 % Change in NPV | At December 31, 2004 NPV | At December 31, 2004 Ratio of NPV to the Present Value of Total Assets | At December 31, 2004 % Change in NPV |
|---|---|---|---|---|---|---|
| | (Dollars in thousands) | | | | | |
| +300 | $ 648,235 | 9.55% | (9.6) | $ 450,691 | 6.62% | (22.0) |
| +200 | 691,863 | 10.08 | (3.6) | 507,295 | 7.35 | (12.2) |
| +100 | 721,389 | 10.42 | 0.6 | 553,335 | 7.91 | (4.3) |
| Static | 717,402 | 10.31 | 0.0 | 577,971 | 8.17 | 0.0 |
| -100 | 632,095 | 09.14 | (11.9) | 527,953 | 7.45 | (8.7) |
| -200 | 473,344 | 06.95 | (34.0) | 369,634 | 5.28 | (36.1) |

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

Sterling calculated its one-year cumulative gap position to be a negative 5.4% and a negative 13.0% at June 30, 2005 and December 31, 2004, respectively. Sterling calculated its three-year gap position to be a positive 6.9% and a negative 9.4% at June 30, 2005 and December 31, 2004, respectively. While the one-year cumulative gap shows liability sensitivity at June 30, 2005, it does not correlate directly to an increased exposure to rising interest rates. During the first quarter of 2005, Sterling restructured certain higher-rate borrowings with extensions, and certain borrowings which had premiums assigned when they were acquired. Additionally, loan prepayment speeds for long-term loans can vary substantially in a rising rate environment. These effects are not considered when calculating traditional gap analysis. As a result of this restructuring and certain loan sales during the six months ended June 30, 2005, management believes that it has improved Sterling s IRR profile and will be able to better manage IRR.

Management attempts to maintain Sterling s gap position between positive 10% and negative 25%. At June 30, 2005 and December 31, 2004, Sterling s gap positions were within limits established by its Board of Directors. Management is pursuing strategies to increase its NII without significantly increasing its cumulative gap positions in future periods. There can be no assurance that Sterling will be successful implementing these strategies or that, if these strategies are implemented, they will have the intended effect of increasing its NII. See Results of Operations *Net Interest Income* and Capital.

**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 9% to $4.20 billion at June 30, 2005 from $3.86 billion at December 31, 2004, mainly due to increases of $257.6 million and $68.1 million, respectively, in time deposits and transaction accounts. The increase in time deposits was primarily due to the increase in interest rates as customers began shifting funds to higher yielding deposit products.

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 six months ended June 30, 2005, net cash provided by investing activities was $211.6 million, which consisted mainly of payment proceeds on the loan and MBS portfolios totaling $1.33 billion, other loan and MBS sales totaling $588.5 million, partially offset by loans funded, purchased and MBS purchases totaling $1.71 billion. During this period, net cash used in financing activities was $225.8 million, which consisted primarily of net repayments on wholesale funding, partially offset by net inflows from time deposits.

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 June 30, 2005, this credit line represented a total borrowing capacity of $2.45 billion, of which $631.6 million was available. On April 5, 2005, the FHLB Seattle announced the submission of a proposed three-year business and capital management plan to its regulator. The FHLB stated that during implementation of this three-year plan, member access to FHLB Seattle funding and liquidity is expected to continue unimpeded. However, the FHLB Seattle indicated that over the next few years, while it implements its new business plan, minimal to no dividends would be available to its members. Based on this guidance, Sterling anticipates a decrease in annual dividend income of approximately $2.0 million.

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 June 30, 2005, Sterling Savings Bank had $536.2 million in outstanding borrowings under reverse repurchase agreements and had securities available for additional secured borrowings of approximately $281.6 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 $11.8 million and $19.2 million at June 30, 2005 and December 31, 2004, respectively. At June 30, 2005 and December 31, 2004, Sterling had an investment of $110.1 million in the preferred stock of Sterling Savings Bank. At June 30, 2005 and December 31, 2004, Sterling had an investment in the common stock of Sterling Savings Bank of $294.6 million. Sterling received cash dividends on Sterling Savings Bank preferred stock of $5.8 million during the six months ended June 30, 2005. These resources contributed to Sterling s ability to meet its operating needs, including interest expense on its long-term debt. Sterling Savings Bank s ability to pay dividends is limited by its earnings, financial condition and capital requirements, as well as regulatory rules. See Note 2 of Notes to Consolidated Financial Statements.

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 July 29, 2005 were as follows:

| Rating Institution | Sterling Long-Term Debt | Sterling Short-Term Debt | Sterling Savings Bank Long-Term Deposits | Outlook |
|---|---|---|---|---|
| Fitch | BB+ | B | BBB- | Positive |

**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 MBO in future periods, especially in rising interest rate environments.

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 MBO 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 June 30, 2005, which resulted in assets of $295,000 and $64,000, respectively. At December 31, 2004, rate locks and forward sales commitments were assets of $76,000 and $12,000, respectively.

**Capital**

Sterling s total shareholders equity was $503.5 million at June 30, 2005 compared with $469.8 million at December 31, 2004. The increase in total shareholders equity was primarily due to the retention of earnings. Shareholders equity was 7.47% of total assets at June 30, 2005 compared with 6.77% at December 31, 2004.

At June 30, 2005, Sterling had an unrealized loss of $10.5 million, net of related income taxes, on investment securities and MBS classified as available for sale. At December 31, 2004, Sterling had an unrealized loss of $9.5 million, net of related income taxes, on investment securities and MBS classified as available for sale. The change since December 31, 2004 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, 2004. Fluctuations in prevailing interest rates continue to cause volatility in this component of accumulated comprehensive income or loss in shareholders equity and may continue to do so in future periods.

Sterling has outstanding various series of capital securities ( Trust Preferred Securities ) issued to investors. The Trust Preferred Securities are treated as debt of Sterling. Although Sterling, as a savings and loan holding company, was not subject to the Federal Reserve capital requirements for bank holding companies, the Trust Preferred Securities were structured to qualify as Tier 1 capital, subject to certain limitations, if Sterling were to become regulated as a bank holding company. For a complete description, see Notes 2 and 9 of Notes to Consolidated Financial Statements.

Sterling Savings Bank is required by applicable regulations to maintain certain minimum capital levels with respect to core (Tier 1) capital, core (Tier 1) risk-based capital and total risk-based capital. Sterling Savings Bank will endeavor to enhance its capital resources and regulatory capital ratios through the retention of earnings and the management of the level and mix of assets, although there can be no assurance in this regard. At June 30, 2005, Sterling Savings Bank exceeded all such regulatory capital requirements and was well-capitalized pursuant to OTS regulations.

The following tables set forth Sterling Savings Bank s core (Tier 1) capital, core (Tier 1) risk-based capital and total risk-based capital positions as reported on the quarterly Thrift Financial Report at June 30, 2005:

| | Minimum Capital Requirements | | Well-Capitalized Requirements | | Actual | |
|---|---|---|---|---|---|---|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| | (Dollars in thousands) | | | | | |
| Total risk-based capital (to risk-weighted assets) | $ 381,810 | 8.00% | $ 477,263 | 10.00% | $ 530,366 | 11.11% |
| Core (Tier 1) risk-based capital (to risk-weighted assets) | 190,905 | 4.00% | 286,358 | 6.00% | 480,146 | 10.06% |
| Core (Tier 1) capital (to adjusted assets) | 264,731 | 4.00% | 330,914 | 5.00% | 480,146 | 7.25% |

**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 December 2004, the FASB issued SFAS No. 123 (revised 2004), Share-Based Payment, which established accounting standards for transactions involving the issuance of equity instruments to employees for services rendered. This statement is a revision of SFAS No. 123, and supersedes APB No. 25. This statement requires the estimation and recognition of the grant date fair value of stock options issued to employees. This statement is effective for Sterling as of January 1, 2006. Management is currently evaluating the effect of this new standard.

In September 2004, the FASB agreed to issue additional guidance on the application of Emerging Issues Task Force ( EITF ) Issue 03-1, The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments. The FASB also deferred the measurement and recognition guidance contained in EITF Issue 03-1. In June 2005, the FASB revised EITF Issue 03-1 by deleting the requirement for investors to demonstrate the ability and intent to hold securities until recovery of impairment. Sterling will continue to apply relevant other-than-temporary guidance to its investment securities and MBS portfolio, as applicable.

In December 2003, the American Institute of Certified Public Accountants issued Statement of Position No. 03-3, Accounting for Certain Loans or Debt Securities Acquired in a Transfer ( SOP No. 03-3 ). SOP No. 03-3 addresses accounting for differences between contractual cash flows and cash flows expected to be collected from an investor s initial investment in loans acquired in a transfer if those differences are attributable, at least in part, to credit quality. SOP No. 03-3 is effective for loans acquired in fiscal years beginning after December 15, 2004. The implementation of SOP No. 03-3 has not had a material effect on Sterling s consolidated financial statements.

**Regulation and Compliance**

Sterling is subject to many laws and regulations applicable to banking activities. As a thrift holding company, Sterling was subject to comprehensive examination and regulation by the OTS. During the second quarter, Sterling Savings Bank, as a Washington State-chartered savings association, was subject to comprehensive regulation and examination by the Washington Supervisor as its chartering authority, the OTS as its primary federal regulator, and by the FDIC, which administers the Savings Association Insurance Fund, which insures Sterling Savings Bank s deposits to the maximum extent permitted by law. As a result of the charter conversion, Sterling will be subject to the Federal Reserve Board s supervision, and Sterling Savings Bank will be subject to supervision by the Washington State Department of Financial Institutions and the FDIC. See Note 9 of Notes to Consolidated Financial Statements. Sterling Savings Bank is a member of FHLB Seattle, which is one of the twelve regional banks, which comprise the FHLB System. Sterling Savings Bank is further subject to regulations of the Board of Governors of the Federal Reserve System governing reserves required to be maintained against deposits and certain other matters.

**Forward-Looking Statements**

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

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

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

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; and

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

**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.

**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 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**

Sterling s Annual Meeting of Shareholders (the Meeting ) was held on April 26, 2005. The following matters were submitted to a vote of the security holders of Sterling at the Meeting:

(1) Election of three Directors to serve for terms expiring in the year 2008:

| | | | | |
|---|---|---|---|---|
| Donald N. Bauhofer | Votes for: | 19,232,484 | Withheld: | 1,248,311 |
| Thomas H. Boone | Votes for: | 20,410,434 | Withheld: | 70,361 |
| Harold B. Gilkey | Votes for: | 19,933,666 | Withheld: | 547,129 |
| | | | Approximate Broker Non-votes: | 0 |

The following are the names of the other Directors whose terms continued after the meeting:

| | |
|---|---|
| Ned M. Barnes | James P. Fugate |
| Rodney W. Barnett | Robert D. Larrabee |
| William Ike L. Eisenhart | William W. Zuppe |

(2) Ratification of the appointment of BDO Seidman, LLP as the independent registered public accounting firm for the year ending December 31, 2005 and any interim periods. The proposal received the following votes:

| | | | | | |
|---|---|---|---|---|---|
| Votes for: | 20,348,749 | Against: | 105,258 | Abstentions: | 26,788 |
| | | | Approximate Broker Non-votes: | | 0 |

**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.

**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)

| | | |
|---|---|---|
| August 9, 2005<br>Date | By: | /s/ Daniel G. Byrne<br>**Daniel G. Byrne**<br>Executive Vice President, Assistant Secretary, and Chief Financial Officer |
| August 9, 2005<br>Date | By: | /s/ William R. Basom<br>**William R. Basom**<br>Vice President, Treasurer, and Principal Accounting Officer |

| Exhibit No. | Exhibit Index |
|---|---|
| 3.1 | Restated Articles of Incorporation of Sterling. Filed as Exhibit 3.1 to Sterling s report on Form 10-Q dated May 15, 2003 and incorporated by reference herein. |
| 3.2 | Amended and Restated Bylaws of Sterling. Filed as Exhibit 3.3 to Sterling s Registration Statement on Form S-4 dated December 9, 2002 and incorporated by reference herein. |
| 4.1 | Reference is made to Exhibits 3.1 and 3.2. |
| 4.2 | Sterling has outstanding certain long-term debt. None of such debt exceeds ten percent of Sterling s total assets; therefore, copies of the constituent instruments defining the rights of the holders of such debt are not included as exhibits. Copies of instruments with respect to such long-term debt will be furnished to the Securities and Exchange Commission upon request. |
| 10.1 | Credit agreement dated May 18, 2005, by and among Sterling, as Borrower, and Bank of Scotland, as Lender, Administrative Agent and Collateral Agent. Filed as Exhibit 10.1 to Sterling s report on Form 8-K filed May 20, 2005 and incorporated by reference herein. |
| 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. |