STERLING FINANCIAL CORP /WA/
Form 10-K
March 16, 2010
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the year ended DECEMBER 31, 2009

OR

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

For the transition period from to

COMMISSION FILE NUMBER 0-20800

STERLING FINANCIAL CORPORATION

(Exact name of registrant as specified in its charter)

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

111 North Wall Street, Spokane, Washington 99201

(Address of principal executive offices) (Zip code)

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

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

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

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

Common Stock ($1.00 par value)

(Title of class)

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

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ¨ No ¨

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

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

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

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

As of June 30, 2009, the aggregate market value of the common equity held by non-affiliates of the registrant, computed by reference to the average of the bid and asked prices on such date as reported by the NASDAQ Global Select Market, was $147 million.

The number of shares outstanding of the registrant s common stock, par value $1.00 per share, as of January 31, 2010 was 52,167,895.

DOCUMENTS INCORPORATED BY REFERENCE

Specific portions of the registrant s Proxy Statement for its 2010 annual meeting of shareholders are incorporated by reference into Part III hereof.

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STERLING FINANCIAL CORPORATION

DECEMBER 31, 2009 ANNUAL REPORT ON FORM 10-K

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PART I

This report contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. For a discussion of the risks and uncertainties inherent in such statements, see Business Forward-Looking Statements and Risk Factors.

Item 1. Business

General

Sterling Financial Corporation (Sterling) is a bank holding company, organized under the laws of Washington State in 1992. The principal operating subsidiaries of Sterling are Sterling Savings Bank and Golf Savings Bank. Sterling Savings Bank, headquartered in Spokane, Washington, commenced operations in 1983 as a Washington State-chartered federally insured stock savings and loan association, and in 2005 converted to a commercial bank. Sterling Savings Bank offers commercial banking products and services, mortgage lending, construction financing and investment products to individuals, small business, commercial organization and corporations. The main focus of Golf Savings Bank, a Washington State-chartered savings bank acquired by Sterling in July 2006, is the origination and sale of residential mortgage loans.

At December 31, 2009, Sterling had total assets of $10.9 billion, total liabilities, including deposits, of $10.6 billion and total shareholders equity of $323.2 million and operated 178 deposit-taking branches throughout the Western region of the United States, including the states of Washington, Oregon, Idaho, Montana and California. Our common stock is listed on the Nasdaq Global Select Market under the symbol STSA. Our principal offices are located at 111 North Wall Street, Spokane, Washington 99201 and our telephone number at that address is (509) 227-5389. We maintain an Internet website at www.sterlingfinancialcorporation-

spokane.com. Neither this website nor the information on this website is included or incorporated in, or is a part of, this Annual Report on Form 10-K.

Recent Developments

Sterling faces a number of challenges resulting from current and prior year losses, driven by credit quality issues, and is categorized as being undercapitalized by regulatory guidelines. In the fourth quarter of 2009, Sterling Savings Bank entered into a Stipulation and Consent to the Issuance of an Order to Cease and Desist (the SSB Consent Agreement) with the Federal Deposit Insurance Corporation (FDIC) and the Washington State Department of Financial Institutions (WDFI). Under the terms of the agreement, Sterling Savings Bank has agreed to, among other things, raise capital of at least $300 million, and maintain a Tier 1 leverage ratio of not less than 10%. The agreement set a deadline of December 15, 2009 for meeting these capital requirements, which Sterling was not able to meet. During the fourth quarter, Sterling and the Federal Reserve Bank of San Francisco (the Reserve Bank) entered into a written agreement (the Reserve Bank Agreement) to enhance Sterling s ability to act as a source of strength to Sterling Savings Bank and Golf Savings Bank. Substantially all of the requirements of the Reserve Bank Agreement are similar to those imposed on Sterling Savings Bank by the FDIC. Sterling Savings Bank has failed to increase its Tier 1 capital to the levels required by the SSB Consent Agreement and does not comply with certain of the

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requirements of the Reserve Bank Agreement and the SSB Consent Agreement. The uncertainty around Sterling s ability to comply with these agreements has raised substantial doubts about Sterling s ability to continue as a going concern. See Risk Factors, Forward-Looking Statements, Regulation Federal and State Regulation of Banking Activities and Note 25 of Notes to Consolidated Financial Statements.

During the fourth quarter, Sterling announced a management change that resulted in the appointment of a new President and Chief Executive Officer, a new Chief Operating Officer, as well as a new Chairman of the Board. This new Executive management team developed several strategies to address the capital and liquidity needs of the organization. In March 2010, the following Directors of Sterling Savings Bank were appointed to serve as Directors of Sterling: Ned M. Barnes, Rodney W. Barnett, Thomas H. Boone, Kermit K. Houser and Dianne E. Spires.

Sterling is in active negotiations with several private equity investors, two of its major stakeholders and its regulators about various strategic alternatives designed to put Sterling on a sound financial footing and allow it to recapitalize and grow its business.

Sterling s recovery plan is expected to include a restructuring of its capital and liabilities. As such, Sterling has been actively engaged with two of its major stakeholders, the owners of its outstanding trust preferred securities (TruPS) and U.S. Department of the Treasury (Treasury), which holds preferred stock that Sterling issued as part of Treasury s Capital Purchase Program, which was designed to support the health of the nation s banking sector.

As part of that plan, Sterling requested and received a letter from the Treasury expressing conditional support for a plan to convert the Sterling preferred stock that Treasury holds into Sterling common stock. In addition, Sterling has received several non-binding proposals from private equity firms, and has entered into a non-binding letter of intent with one of these firms to provide additional capital to recapitalize Sterling.

In its letter, Treasury set forth several conditions for its approval of the conversion of Treasury-owned securities to common equity. Among other things, Sterling must obtain the consent for the redemption of Sterling s TruPS by a substantial portion of the holders of those securities; must raise at least $650 million of additional capital through the issuance of new common equity at not greater than 20 cents per share; and must execute a definitive agreement for that conversion with Treasury. As a result of these alternatives, current shareholders are expected to have no more than a minimal stake in Sterling in the future.

Sterling also continues to consider and explore these and other alternatives, including the raising of capital through public or private equity offerings; the potential sale of Sterling or some or all of its assets; or other substantial adjustments to Sterling s balance sheet. All proposals received by Sterling to date, contemplate a conversion of the Treasury s preferred stock at a discount to the face value, and the exchange of a substantial portion of the TruPS into cash at a significantly reduced price.

In February 2010, Sterling began making cash offers to repurchase its outstanding series of TruPS at an 80% discount from the stated value. Formal offers have been extended to registered owners of Sterling s managed TruPS series, who have until March 23, 2010 to consent to the terms of Sterling s cash tender offer. Owners of Sterling s unmanaged TruPS series have until March 31, 2010 to consent to the terms of Sterling s cash offer. Sterling s cash tender offer is conditioned upon a successful capital raise, as well as the receipt of all applicable approvals from the Reserve Bank.

Sterling is being assisted in its exploration of these various alternatives by financial advisors Sandler O Neill + Partners, Barclays Capital and FBR Capital Markets.

There can be no assurance that any of these efforts will be successful, and if Sterling were to be unsuccessful, its ongoing viability would be in doubt. Such uncertainty is reflected in the opinion given by our auditors on our year-end financial statements, Forward-Looking Statements and Risk Factors. Regardless of the outcome, Sterling depositors continue to be protected by FDIC insurance up to $250,000 per account, and non-interest-bearing and certain interest-bearing

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transaction accounts are fully protected regardless of dollar amount under the FDIC s Transaction Account Guarantee (TAG) program. See Risk Factors The uncertainty of our financial viability could result in a loss of access to funding sources, which would have a negative impact on our liquidity and may cause our regulators to place us in receivership before we have implemented our strategic alternatives and Regulation.-Recent Legislative and Regulatory Initiatives to address Financial and Economic Crises.

Business Strategy

Sterling s goal is to be the leading community bank in the West by offering customers a range of highly personalized sales and service consistent with our Hometown Helpful® philosophy. This strategy centers on bringing the full product suite of a large regional institution to customers with the personalized service of a local community bank. The four tenets of this philosophy are:

Knowledgeable bankers We are committed to ensuring our employees are highly trained and talented bankers who capably serve consumers and commercial customers across our five-state footprint. Our employee development, training, and compensation initiatives are designed to support the strongest team of bankers in the region.

Fair pricing No one likes to be nickel and dimed. We are dedicated to providing value-driven pricing that generates the appropriate risk-adjusted rate of return and supports our market-driven competitive funding cost advantage. We have eliminated nuisance fees and are focused on creating meaningful value for our customers.

Convenience and ease of use We have 178 retail banking locations and more than 30 mortgage loan origination offices; customer- oriented hours; full-service net banking and bill pay. We have the largest team of commercial bankers in the region and the highest commitment to personalized service. Our goal is to meet our customers where they want to be met.

Competitive products and services We have one of the most advanced and user-friendly Remote Deposit Capture offerings in the western United States. Our treasury management products rival those of the largest banks operating in our area. We offer a full range of consumer, small business, commercial, corporate, wealth and mortgage banking products and services across our five-state footprint.

Sterling believes that its dedication to personalized service and relationship banking has enabled it to grow both its retail deposit base and its lending portfolio in the western United States. Sterling originates loans and attracts FDIC insured and uninsured deposits from the general public throughout its five state footprint through its two subsidiary banks, Sterling Savings Bank and Golf Savings Bank, and through its commercial real estate division INTERVEST-Mortgage Investment Company (INVERVEST). Sterling also markets fixed income and equity products, mutual funds, fixed and variable annuities and other financial products through wealth management representatives located throughout Sterling s financial service center network.

Historically, we have focused on growing our institution both organically and through acquisitions (we have completed eight whole bank acquisitions since our founding). Beginning in mid-2008, and in light of the current economic environment, we shifted our focus to internal improvements with an emphasis on the areas of credit management, operating efficiency and optimally sizing the balance sheet. Our business philosophy transformed from the traditionally effective asset growth model to the back to basics banking model built around development of core relationships. We realigned our organization to increase our profitability by adding seasoned and talented individuals to our operations and by incorporating the following strategies:

Strengthening Asset Quality Oversight and Resolution. To address the deteriorating economic environment in early 2008, Sterling established a credit administration group to focus specifically on the identification and resolution of construction and commercial real estate-related assets that are currently or expected to become problem assets. This group operates independently from a parallel credit administration team dedicated to monitoring

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the performing loans in Sterling s loan portfolio. This separation of duties has allowed Sterling to continue its strategic goal of achieving targeted levels of loan portfolio diversification while addressing issues related to problem assets. In addition, the creation of a sales team to proactively handle the sale of other real estate owned (OREO) has facilitated efficient asset resolution which, in turn, has reduced the negative impact of carrying nonperforming assets on the balance sheet.

Emphasizing Growth in Commercial Business and Consumer Lending While Reducing Exposure to Construction and Commercial Real Estate Loans. Sterling continues to optimize its balance sheet mix to achieve increased risk adjusted returns by rebalancing loan-portfolio concentrations, aligning loan pricing with credit risk and improving the overall mix of earning assets. Since December 31, 2008, construction loans have declined $1.0 billion, or 40%.

Originating Lower-Cost Core Deposits with Relationship Banking Initiatives. We have implemented a number of relationship-focused deposit initiatives over the last two years, resulting in growth of core deposits including non-interest bearing checking accounts. The change in our deposit mix has contributed to Sterling s cost of funds decreasing from 3.13% as of December 31, 2008 to 2.28% as of December 31, 2009. In addition, we expect to realize an increase in deposit-related fee income with the increase in transaction deposit account activity. We expect the growth in core deposits to reduce our reliance on wholesale borrowings as a funding source.

Expanding and Diversifying Our Fee Income. Sterling continues to explore opportunities to grow fee income through existing products and services as well as new sources, including deposit fees, transaction fees and fees from mortgage banking. These activities center around relationship banking and our Hometown Helpful value proposition. We are committed to providing our customers with knowledgeable bankers delivering valuable products and services at a fair price and in a convenient and accessible fashion. Income from mortgage banking operations has grown by $19.6 million, or 71.0%, during the year ended 2009, compared with the same period in 2008.

Improving Operating Efficiency Through Improved Expense Management. In an effort to maximize core earnings and offset credit-related expenses incurred in today s deteriorating credit environment, Sterling has implemented expense savings initiatives. Earlier this year, Sterling Savings Bank revised its branch staffing model and eliminated redundant positions. Through these and other efforts during 2009, Sterling Savings Bank reduced its full-time equivalent branch and administrative staffing by approximately 4.8%.

Improving Capital Levels. For a discussion of the strategic alternatives designed to put Sterling on a sound financial footing and allow it to recapitalize and grow its business, see Recent Developments.

As we complete the organizational shift away from asset-driven growth to profit-driven core relationship banking, we will continue to emphasize maximizing the effectiveness of our funding costs. Initially, our priorities are balanced, aggressive, deposit growth and timely, cost-effective, asset resolution. In the future, increasing larger low-cost core funding sources will enable us to generate profitable, high quality assets. We have improved all of our core funding ratios with loans-to-deposits declining 11 percentage points to 94% as of December 31, 2009. We continue to emphasize progress in the realignment of our asset concentrations and the restructuring of our balance sheet.

Sterling s revenues are derived primarily from interest earned on loans and mortgage-backed securities (MBS), fees and service charges, and mortgage banking operations. Sterling s earnings per share and performance ratios for 2009 continued to be impacted by the major disruption in the housing market and downturn in the economy. For the year ended December 31, 2009, Sterling recorded a loss of $855.5 million, or $16.48 per common share, reflecting a $681.4 million provision for credit losses compared with $333.6 million for 2008, and recorded non-cash charges of $227.6 million to

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reflect impairment of Sterling s goodwill, and of $269.0 million to establish a valuation allowance against its deferred tax asset. During the third quarter of 2009, Sterling announced that, as part of its ongoing strategy to manage through the current economic cycle, it deferred regularly scheduled interest payments on its outstanding junior subordinated notes relating to its trust preferred securities. Sterling also announced the deferral of quarterly cash dividend payments on its $303 million in preferred stock. Sterling is allowed to defer payments of interest on the junior subordinated notes for up to 20 consecutive quarterly periods without default. Failure to pay dividends on CPP preferred stock for six dividend periods would trigger preferred shareholder board appointment rights.

The operations of Sterling, and banking institutions generally, are influenced significantly by general economic conditions and by policies of its primary regulatory authorities, the Board of Governors of the Federal Reserve System (the Federal Reserve), the FDIC and the WDFI.

Profitability Drivers

We intend to return to profitability by:

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

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

Segment Results

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

- The Community Banking segment provides retail, commercial banking, and wealth management services and products through Sterling s subsidiary, Sterling Savings Bank.

The Residential Construction Lending segment has historically originated and serviced loans through the real estate division of Sterling s subsidiary, Sterling Savings Bank. Activity in this segment has been curtailed, and realigned with an emphasis on credit resolution.

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

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

The Other and Eliminations segment represents the parent company expenses and intercompany eliminations of revenue and expenses. On May 1, 2009, Sterling Savings Bank s subsidiary, Harbor Financial Services, Inc., which provides certain wealth management services, was renamed Sterling Savings Banc Financial Services, Inc.

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The following table presents certain financial information regarding Sterling s segments and provides a reconciliation to Sterling s consolidated totals as of and for the years ended December 31, 2009, 2008 and 2007 (in thousands):

	As of and for the Year Ended December 31, 2009					
	Community Banking	Residential Construction Lending	Residential Mortgage Banking	Commercial Mortgage Banking	Other and Eliminations	Total
Interest income	$ 538,503	$ 7,951	$ 29,058	$ 22,912	$ 923	$ 599,347
Interest expense	(194,836)	(39,633)	(13,587)	0	(7,314)	(255,370)
Net interest income (expense)	343,667	(31,682)	15,471	22,912	(6,391)	343,977
Provision for losses on loans	(389,293)	(267,835)	(24,243)	0	0	(681,371)
Noninterest income	77,465	304	54,771	2,891	(11,617)	123,814
Noninterest expense	(309,280)	(7,273)	(39,565)	(8,299)	(5,557)	(369,974)
Goodwill impairment	(227,558)	0	0	0	0	(227,558)
Income (loss) before income taxes	$ (504,999)	$ (306,486)	$ 6,434	$ 17,504	$ (23,565)	$ (811,112)
Total assets	$ 9,302,660	$ 969,935	$ 586,765	$ 18,074	$ (11)	$ 10,877,423

	As of and for the Year Ended December 31, 2008					
	Community Banking	Residential Construction Lending	Residential Mortgage Banking	Commercial Mortgage Banking	Other and Eliminations	Total
Interest income	$ 565,767	$ 99,027	$ 30,559	$ 18,962	$ 747	$ 715,062
Interest expense	(262,637)	(62,492)	(17,570)	0	(12,811)	(355,510)
Net interest income (expense)	303,130	36,535	12,989	18,962	(12,064)	359,552
Provision for losses on loans	(105,915)	(221,135)	(6,547)	0	0	(333,597)
Noninterest income	70,444	3,234	23,672	3,803	(9,258)	91,895
Noninterest expense	(253,189)	(9,766)	(29,005)	(9,463)	(4,094)	(305,517)
Goodwill impairment	(192,695)	0	(31,070)	0	0	(223,765)
Income (loss) before income taxes	$ (178,225)	$ (191,132)	$ (29,961)	$ 13,302	$ (25,416)	$ (411,432)
Total assets	$ 10,721,836	$ 1,526,416	$ 517,728	$ 14,958	9,778	$ 12,790,716

	As of and for the Year Ended December 31, 2007					
	Community Banking	Residential Construction Lending	Residential Mortgage Banking	Commercial Mortgage Banking	Other and Eliminations	Total
Interest income	$ 548,815	$ 185,090	$ 23,863	$ 9,000	$ 210	$ 766,978
Interest expense	(274,100)	(104,758)	(14,462)	0	(18,298)	(411,618)
Net interest income (expense)	274,715	80,332	9,401	9,000	(18,088)	355,360
Provision for losses on loans	11,047	(35,752)	(383)	0	0	(25,088)
Noninterest income	81,663	6,945	21,012	7,496	(23,710)	93,406
Noninterest expense	(230,753)	(10,395)	(30,584)	(10,970)	(2,763)	(285,465)
Income (loss) before income taxes	$ 136,672	$ 41,130	$ (554)	$ 5,526	$ (44,561)	$ 138,213

Total assets	$ 9,999,348	$ 1,847,344	$ 399,306	$ 10,445	$ (106,668)	$ 12,149,775

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Lending Activities

Sterling provides both secured and unsecured loans to businesses and individuals. Our focus on superior service and relationship banking incorporates a de-emphasis on transactional lending, especially construction and investor or non-owner occupied commercial real estate lending.

Commercial Lending. Sterling has structured its commercial lending into three groups: Commercial and Corporate Banking, Private Banking and Small Business Administration (SBA) Lending.

Sterling s Commercial and Corporate Banking Group provides a full range of credit products to small- and medium-sized businesses. Credit products include lines of credit, receivable and inventory financing, equipment loans, and term real estate financing for owner-occupied properties. Loans may be fully secured, partially secured or unsecured, based on certain credit criteria. The credit product line for both businesses and individuals includes standardized products as well as customized accommodations.

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

Sterling s Small Business Administration Group consists of business development officers strategically located in Sterling s key business markets of Seattle, WA, Portland, OR, Spokane, WA and Santa Rosa, CA. Sterling s business development officers assist small start-up and existing businesses with their financing, cash management and general business planning needs, primarily by helping them access the Small Business Administration s guaranteed 7(a) and 504 lending programs. These guaranteed lending programs provide small businesses with critical and flexible funding for establishing a new business, or for the operation, acquisition or expansion of an existing business. From their four primary locations, Sterling s business development officers support small businesses banking requirements throughout Sterling s Commercial and Retail branch network.

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

Commercial, corporate and private banking loans generally are backed by collateral that may be difficult to obtain or liquidate following a default, and it is difficult to accurately predict the borrower s ability to generate future cash flows. These loans, however, typically offer higher yields than residential loans, and variable interest rates. The availability of such loans generally encourages potential depositors to establish full-service banking relationships with Sterling.

Multifamily Residential and Commercial Real Estate Lending. Sterling offers multifamily residential and commercial real estate loans as both construction and permanent loans collateralized by real property. Construction loans on such properties typically have terms of 12 to 24 months and have variable interest rates. Permanent fixed- and adjustable-rate loans on existing properties typically have maturities of three to ten years. Multifamily residential and commercial real estate loans generally involve a higher degree of risk than one- to four-family residential real estate loans, because they typically involve large loan balances to single borrowers or groups of related borrowers. The payment experience on such loans typically is dependent on the successful operation of the real

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estate project and is subject to certain risks not present in one- to four-family residential mortgage lending. These risks include excessive vacancy rates or inadequate operating cash flows. Construction lending is subject to risks such as construction delays, cost overruns, insufficient values and an inability to obtain permanent financing in a timely manner. Sterling has seen a slowdown in the rate at which newly constructed commercial properties are able to obtain tenants, which has impacted some of its borrowers ability to obtain permanent financing. Sterling attempts to reduce its exposure to these risks by limiting loan amounts to the amounts readily accepted in the secondary market, by closely monitoring the construction disbursement process, by investigating the borrowers finances and, depending on the circumstances, requiring annual financial statements from the borrowers, requiring operating statements on the properties or acquiring personal guarantees from the borrowers.

One- to Four-Family Residential Lending. Sterling originates fixed- and adjustable-rate residential mortgages (ARMs), which have interest rates that adjust annually or every three, five or seven years and are indexed to a variety of market indices, as well as interest only residential mortgages. Sterling focuses its residential lending on traditional amortizing loans for owner occupied homes, second homes and investment properties per guidelines. Sterling also has interest only loan programs available that are underwritten according to the borrower s ability to make fully amortized payments. To a lesser extent, Sterling originates non-owner occupied residential mortgages. With the slowdown in the real estate market, Sterling has experienced a substantial increase in classified and non-performing loans in its non-owner occupied residential loan portfolio.

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

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

Sterling originates residential construction loans on presold and spec homes, as well as townhouses and condominiums and provides land, lot, and acquisition and development loans for residential subdivisions. However, in the current economic environment, the number of viable residential construction projects that meet Sterling s underwriting standards is limited. Construction financing is generally considered to involve a higher degree of risk than long-term financing on improved, occupied real estate. Sterling s risk of loss on construction loans depends largely upon the accuracy of the initial estimate of the property s value at completion of construction or development and the estimated cost (including interest) of construction. If the estimate of construction costs proves to be inaccurate, Sterling might have to advance funds beyond the amount originally committed to permit completion of the development and to protect its security position. Sterling also might be confronted, at or prior to maturity of the loan, with a project with insufficient value to ensure full repayment. Sterling s underwriting, monitoring and disbursement practices with respect to construction financing are intended to ensure that sufficient funds are available to complete construction projects. Sterling has seen a deterioration of the credit quality of its residential construction portfolio as evidenced by the increase

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in classified and non-performing construction loans. Sterling endeavors to limit its risk through its underwriting procedures by using only approved, qualified appraisers and by dealing only with qualified builders/borrowers. See Classified and Non-performing Assets.

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

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

	Years Ended December 31,					
	2009		2008		2007	
	Amount	%	Amount	%	Amount	%
	(Dollars in thousands)					
Mortgage:						
One- to four-family residential	$ 3,047,380	76.5	$ 1,464,673	40.4	$ 1,492,026	27.2
Multifamily residential	82,696	2.1	170,975	4.7	35,870	0.7
Commercial real estate	176,256	4.4	326,853	9.0	163,315	3.0
Total mortgage loans	3,306,332	83.0	1,962,501	54.1	1,691,211	30.9
Construction:						
One- to four-family residential	32,692	0.8	383,922	10.6	1,584,449	28.9
Multifamily residential	0	0.0	25,374	0.7	118,799	2.2
Commercial real estate	31,968	0.8	192,755	5.3	488,372	8.9
Total construction loans	64,660	1.6	602,051	16.6	2,191,620	40.0
Total mortgage and construction loans	3,370,992	84.6	2,564,552	70.7	3,882,831	70.9
Commercial and consumer:						
Commercial banking	318,544	8.0	541,978	15.0	995,732	18.2
Consumer direct	191,789	4.8	326,763	9.0	359,338	6.6
Consumer indirect	99,813	2.6	190,177	5.3	242,309	4.3
Total commercial and consumer loans	610,146	15.4	1,058,918	29.3	1,597,379	29.1
Total loans originated	$ 3,981,138	100.0	$ 3,623,470	100.0	$ 5,480,210	100.0

Construction loan originations were lower for both 2009 and 2008, as compared to 2007, reflecting both Sterling s strategic efforts to reduce the concentration of these loans in its loan portfolio, and current economic conditions that have caused a decline in demand for these loans.

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

	December 31,									
	2009		2008		2007		2006		2005	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
	(Dollars in thousands)									
Mortgage:										
One- to four-family residential	$ 839,170	10.9	$ 867,384	9.6	$ 703,826	7.8	$ 654,661	9.2	$ 488,633	9.9
Multifamily residential	517,408	6.7	477,615	5.3	389,388	4.3	263,053	3.7	332,211	6.7
Commercial real estate	1,403,560	18.2	1,364,885	15.1	1,223,036	13.5	795,386	11.2	792,219	16.0
Total mortgage loans	2,760,138	35.8	2,709,884	30.0	2,316,250	25.6	1,713,100	24.1	1,613,063	32.6
Construction:										
One- to four-family residential	720,964	9.4	1,455,860	16.1	1,933,125	21.3	1,429,772	20.1	591,362	11.9
Multifamily residential	233,501	3.0	324,818	3.6	263,873	2.9	189,819	2.7	143,272	2.9
Commercial real estate	561,643	7.3	754,017	8.4	747,913	8.2	671,291	9.4	286,868	5.8