

STERLING FINANCIAL CORP /WA/  
Form 10-Q  
August 09, 2004

# UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

## FORM 10-Q

(Mark One)

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

FOR THE QUARTERLY PERIOD ENDED June 30, 2004

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)

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**Washington**  
(State or other jurisdiction of  
incorporation or organization)

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

**111 North Wall Street, Spokane, Washington 99201**  
(Address of principal executive offices) (Zip Code)

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

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

Yes  No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

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

| <b>Class</b>                    | <b>Outstanding as of July 30, 2004</b> |
|---------------------------------|--|
| Common Stock (\$1.00 par value) | 22,638,002                             |

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**STERLING FINANCIAL CORPORATION**

**FORM 10-Q**

**For the Quarter Ended June 30, 2004**

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**PART I - Financial Information****Item 1 - Financial Statements****STERLING FINANCIAL CORPORATION****Consolidated Balance Sheets****(Unaudited)**

|  | June 30,<br>2004 | December 31,<br>2003 |
|--|------------------|----------------------|
| (Dollars in thousands)   |                  |                      |
| <b>ASSETS:</b>   |                  |                      |
| Cash and cash equivalents:   |                  |                      |
| Interest bearing   | \$ 1             | \$ 1                 |
| Non-interest bearing and vault   | 92,593           | 65,478               |
| Restricted   | 1,303            | 1,504                |
| Investments and asset-backed securities ( ABS ):   |                  |                      |
| Available for sale   | 2,015,243        | 1,070,955            |
| Held to maturity   | 2,228            | 2,229                |
| Loans receivable, net  | 3,721,991        | 2,906,426            |
| Loans held for sale  | 39,497           | 14,616               |
| Accrued interest receivable  | 24,151           | 16,531               |
| Real estate owned, net   | 4,629            | 4,226                |
| Office properties and equipment, net   | 77,570           | 54,620               |
| Bank-owned life insurance ( BOLI )   | 91,703           | 73,141               |
| Goodwill   | 128,110          | 45,075               |
| Other intangible assets  | 20,959           | 2,881                |
| Mortgage servicing rights, net   | 3,472            | 3,500                |
| Prepaid expenses and other assets, net   | 35,661           | 18,138               |
| Total assets   | \$ 6,259,111     | \$ 4,279,321         |
| <b>LIABILITIES:</b>  |                  |                      |
| Deposits   | \$ 3,600,639     | \$ 2,455,076         |
| Advances from Federal Home Loan Bank of Seattle ( FHLB Seattle )   | 1,336,439        | 1,026,031            |
| Securities sold subject to repurchase agreements and funds purchased   | 659,262          | 363,137              |
| Other borrowings   | 169,134          | 137,998              |
| Cashiers checks issued and payable   | 18,985           | 17,624               |
| Borrowers reserves for taxes and insurance   | 3,570            | 1,347                |
| Accrued interest payable   | 11,641           | 8,223                |
| Accrued expenses and other liabilities   | 51,219           | 19,537               |
| Total liabilities  | 5,850,889        | 4,028,973            |
| Commitments and Contingencies  |                  |                      |
| <b>SHAREHOLDERS EQUITY:</b>  |                  |                      |
| 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; 22,614,706 and 14,863,917 shares issued and outstanding | 22,615           | 14,864               |
| Additional paid-in capital   | 384,654          | 181,382              |
| Accumulated other comprehensive income (loss):   |                  |                      |

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|   |              |              |
|---|--------------|--------------|
| Unrealized gains (losses) on investments and ABS available-for-sale, net of deferred income taxes of \$16,877 and \$8,181 | (31,342)     | (15,193)     |
| Retained earnings   | 32,295       | 69,295       |
| Total shareholders' equity  | 408,222      | 250,348      |
| Total liabilities and shareholders' equity  | \$ 6,259,111 | \$ 4,279,321 |

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

## STERLING FINANCIAL CORPORATION

## Consolidated Statements of Income

(Unaudited)

|   | Three Months Ended<br>June 30,                |            | Six Months Ended<br>June 30, |            |
|---|---|------------|------------------------------|------------|
|   | 2004  | 2003       | 2004                         | 2003       |
|   | (Dollars in thousands, except per share data) |            |                              |            |
| <b>Interest income:</b>                                 |   |            |                              |            |
| Loans   | \$ 55,725                                     | \$ 42,376  | \$ 108,059                   | \$ 82,715  |
| ABS   | 20,055  | 9,214      | 39,343                       | 19,186     |
| Investments and cash equivalents                        | 1,460   | 1,061      | 3,229                        | 2,235      |
| Total interest income                                   | 77,240  | 52,651     | 150,631                      | 104,136    |
| <b>Interest expense:</b>                                |   |            |                              |            |
| Deposits  | 12,386  | 9,493      | 24,537                       | 18,513     |
| Short-term borrowings                                   | 4,877   | 2,695      | 8,711                        | 5,466      |
| Long-term borrowings                                    | 11,253  | 10,423     | 22,970                       | 21,546     |
| Total interest expense                                  | 28,516  | 22,611     | 56,218                       | 45,525     |
| Net interest income                                     | 48,724  | 30,040     | 94,413                       | 58,611     |
| Provision for losses on loans                           | (3,000)                                       | (2,550)    | (5,850)                      | (4,800)    |
| Net interest income after provision for losses on loans | 45,724  | 27,490     | 88,563                       | 53,811     |
| <b>Other income:</b>                                    |   |            |                              |            |
| Fees and service charges                                | 8,434   | 4,909      | 16,720                       | 9,208      |
| Mortgage banking operations                             | 1,769   | 2,496      | 2,963                        | 4,713      |
| Loan servicing fees (costs)                             | 160   | (153)      | 306                          | (69)       |
| Net gains on sales of securities                        | 848   | 1,677      | 3,307                        | 3,037      |
| Real estate owned operations                            | (341)   | (180)      | (316)                        | (209)      |
| BOLI  | 1,084   | 968        | 2,253                        | 1,790      |
| Charge related to early repayment of debt               | 0   | 0          | 0                            | (1,464)    |
| Other noninterest income (expense)                      | (145)   | (28)       | (526)                        | (208)      |
| Total other income                                      | 11,809  | 9,689      | 24,707                       | 16,798     |
| Operating expenses                                      | 37,088  | 22,604     | 74,807                       | 44,015     |
| Income before income taxes                              | 20,445  | 14,575     | 38,463                       | 26,594     |
| Income tax provision                                    | (6,962)                                       | (5,058)    | (12,996)                     | (9,294)    |
| Net income  | \$ 13,483                                     | \$ 9,517   | \$ 25,467                    | \$ 17,300  |
| Earnings per share - basic                              | \$ 0.60                                       | \$ 0.59    | \$ 1.13                      | \$ 1.10    |
| Earnings per share - diluted                            | \$ 0.58                                       | \$ 0.57    | \$ 1.10                      | \$ 1.08    |
| Weighted average shares outstanding - basic             | 22,589,109                                    | 16,248,879 | 22,471,725                   | 15,668,650 |

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|   |            |            |            |            |
|---|------------|------------|------------|------------|
| Weighted average shares outstanding - diluted | 23,100,053 | 16,624,743 | 23,051,526 | 16,026,438 |
|---|------------|------------|------------|------------|

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

## STERLING FINANCIAL CORPORATION

## Consolidated Statements of Cash Flows

(Unaudited)

|   | Six Months Ended<br>June 30, |             |
|---|------------------------------|-------------|
|   | 2004                         | 2003        |
|   | (Dollars in thousands)       |             |
| Cash flows from operating activities:   |                              |             |
| Net income  | \$ 25,467                    | \$ 17,300   |
| Adjustments to reconcile net income to net cash provided by operating activities: |                              |             |
| Provisions for losses on loans and real estate owned                              | 5,855                        | 4,945       |
| Stock dividends on FHLB Seattle stock   | (1,373)                      | (2,928)     |
| Net gain on sales of loans, investments and ABS                                   | (4,526)                      | (6,387)     |
| Other losses  | 83                           | 113         |
| Change in cash surrender value of BOLI  | (2,253)                      | (1,790)     |
| Depreciation and amortization   | 7,475                        | 5,806       |
| Change in:  |                              |             |
| Accrued interest receivable   | (1,109)                      | (1,309)     |
| Prepaid expenses and other assets   | 4,143                        | 6,578       |
| Cashiers checks issued and payable  | 1,361                        | (1,888)     |
| Accrued interest payable  | 1,304                        | 323         |
| Accrued expenses and other liabilities  | (7,542)                      | 777         |
| Proceeds from sales of loans  | 85,820                       | 209,735     |
| Loans originated for sale   | (84,601)                     | (206,385)   |
| Net cash provided by operating activities   | 30,104                       | 24,890      |
| Cash flows from investing activities:   |                              |             |
| Change in restricted cash   | 201                          | (7,439)     |
| Loans funded  | (1,304,323)                  | (1,074,374) |
| Loan principal received   | 1,023,869                    | 828,734     |
| Purchase of investments   | (229,460)                    | (11,853)    |
| Proceeds from maturities of investments   | 225,285                      | 1,531       |
| Proceeds from sales of available-for-sale investments                             | 95,603                       | 10,681      |
| Cash and cash equivalents acquired as part of mergers                             | 44,894                       | 143,631     |
| Purchase of BOLI  | 0                            | (10,000)    |
| Purchase of ABS   | (710,378)                    | (991,720)   |
| Principal payments on ABS   | 188,378                      | 166,722     |
| Proceeds from sales of ABS  | 259,308                      | 581,160     |
| Purchase of office properties and equipment                                       | (5,996)                      | (2,150)     |
| Improvements and other changes to real estate owned                               | 213                          | 123         |
| Proceeds from sales and liquidation of real estate owned                          | 1,633                        | 1,875       |
| Net cash used in investing activities   | (410,773)                    | (363,079)   |

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





|  | Six Months Ended<br>June 30, |           |
|--|------------------------------|-----------|
|  | 2004                         | 2003      |
|  | (Dollars in thousands)       |           |
| <b>Cash flows from financing activities:</b>                                       |                              |           |
| Net change in checking, regular savings and money market deposits                  | \$ 97,568                    | \$ 54,404 |
| Proceeds from issuance of time deposits  | 1,068,064                    | 785,335   |
| Payments for maturing time deposits  | (1,031,191)                  | (661,334) |
| Interest credited to deposits  | 23,258                       | 16,983    |
| Advances from FHLB Seattle   | 518,464                      | 296,102   |
| Repayment of FHLB Seattle advances   | (569,823)                    | (185,072) |
| Net change in securities sold subject to repurchase agreements and funds purchased | 296,125                      | 27,189    |
| Proceeds from other borrowings   | 0                            | 54,000    |
| Repayment of other borrowings  | (280)                        | (41,900)  |
| Payments for fractional shares and certain merger costs                            | (240)                        | (30)      |
| Proceeds from exercise of stock options, net of repurchases                        | 3,914                        | 583       |
| Deferred financing costs   | 0                            | (732)     |
| Other  | 1,925                        | 236       |
| Net cash provided by financing activities  | 407,784                      | 345,764   |
| Net change in cash and cash equivalents  | 27,115                       | 7,575     |
| Cash and cash equivalents, beginning of period                                     | 65,479                       | 77,065    |
| Cash and cash equivalents, end of period   | \$ 92,594                    | \$ 84,640 |
| <b>Supplemental disclosures:</b>   |                              |           |
| <b>Cash paid during the period for:</b>  |                              |           |
| Interest   | \$ 52,800                    | \$ 46,299 |
| Income taxes   | 11,105                       | 9,457     |
| <b>Noncash financing and investing activities:</b>                                 |                              |           |
| Loans converted into real estate owned   | 1,794                        | 1,309     |
| Common stock dividend  | 62,468                       | 28,699    |
| Common stock issued upon business combination                                      | 145,166                      | 28,107    |

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

## STERLING FINANCIAL CORPORATION

## Consolidated Statements of Comprehensive Income

(Unaudited)

|  | Three Months Ended<br>June 30, |          | Six Months Ended<br>June 30, |           |
|--|--------------------------------|----------|------------------------------|-----------|
|  | 2004                           | 2003     | 2004                         | 2003      |
|  | (Dollars in thousands)         |          |                              |           |
| Net income   | \$ 13,483                      | \$ 9,517 | \$ 25,467                    | \$ 17,300 |
| Other comprehensive income:  |                                |          |                              |           |
| Change in unrealized gains (losses) on investments<br>and ABS available-for-sale | (55,670)                       | (6,943)  | (24,845)                     | (6,745)   |
| Less deferred income taxes   | 19,485                         | 2,430    | 8,696                        | 2,361     |
| Net other comprehensive income (loss)  | (36,185)                       | (4,513)  | (16,149)                     | (4,384)   |
| Comprehensive income (loss)  | \$ (22,702)                    | \$ 5,004 | \$ 9,318                     | \$ 12,916 |

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, 2003. In the opinion of management, the unaudited interim consolidated financial statements furnished herein include all adjustments, all of which are of a normal recurring nature, necessary for a fair statement of the results for the interim periods presented.

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

**2. Other Borrowings:**

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

|  | June 30,<br>2004 | December 31,<br>2003 |
|--|------------------|----------------------|
| Term note payable(1)   | \$ 22,000        | \$ 22,000            |
| Advances on revolving line of credit(2)  | 0                | 0                    |
| Sterling obligated mandatorily redeemable preferred capital securities of subsidiary trusts holding solely junior subordinated deferrable interest debentures of Sterling(3) | 109,282          | 80,415               |
| Floating Rate Notes Due 2006(4)  | 30,000           | 30,000               |
| Other(5)   | 7,852            | 5,583                |
| Total  | \$ 169,134       | \$ 137,998           |

(1) Sterling has a \$22.0 million variable-rate term note with U.S. Bank, N.A. ( U.S. Bank ). This note matures on September 17, 2007. Interest accrues at the 30-day London Interbank Offering Rate ( LIBOR ) plus 2.00% (for a total of 3.11% at June 30, 2004) and is payable monthly. Principal payments are due in annual installments of \$3.0 million each September, with the entire unpaid balance due at maturity. This note is collateralized by a majority of the Common and Preferred Stock of Sterling Savings Bank.

(2) Sterling has a \$5.0 million revolving line of credit with U.S. Bank. This line of credit expires on September 15, 2004. The interest rate is adjustable monthly at the 30-day LIBOR plus 2.00% and is payable monthly. This line of credit is collateralized by a majority of the Common and Preferred Stock of Sterling Savings Bank. At June 30, 2004, no amount was outstanding on this line of credit.

(3) Sterling raises capital from time to time through the formation of trusts ( Sterling Capital Trusts ), which issue capital securities ( Trust Preferred Securities ) to investors. Sterling also acquired two trusts in connection with a merger in January 2004. The Sterling Capital Trusts are business trusts in which Sterling owns all of the common equity. The proceeds from the sale of the Trust Preferred Securities are used to purchase junior subordinated deferrable interest debentures ( Junior Subordinated Debentures ) issued by Sterling. Sterling's obligations under the Junior Subordinated Debentures and related documents, taken together, constitute a full and unconditional guarantee by Sterling of Sterling Capital Trusts' obligations under the Trust Preferred Securities. In accordance with Interpretation No. 46 (Revised), Consolidation of Variable Interest Entities ( FIN No. 46R ), the trusts are not consolidated and the Trust Preferred Securities and related amounts are treated as debt of Sterling. Although Sterling, as a savings and loan holding company, is not subject to the Federal Reserve capital requirements for bank holding companies, the Trust Preferred Securities have been structured to qualify as Tier 1 capital, subject to certain limitations, if Sterling were to become regulated as a bank holding company. The Junior Subordinated Debentures and related Trust Preferred Securities generally mature 30 years after issuance and are redeemable at the option of Sterling under certain conditions. Interest is paid quarterly or semi-annually. Details of the Trust Preferred Securities are as follows:

| Subsidiary Issuer                  | Issue Date | Maturity Date | Call Date  | Mandatorily Redeemable Capital Security | Rate at June 30, 2004 | Amount (in Thousands) |
|------------------------------------|------------|---------------|------------|---|-----------------------|-----------------------|
| Sterling Capital Trust VI          | June 2003  | Sept 2033     | Sept 2008  | Floating Rate Capital Securities        | 4.72% \$              | 10,310                |
| Sterling Capital Statutory Trust V | May 2003   | May 2033      | June 2008  | Floating Rate Capital Securities        | 4.84%                 | 20,619                |
| Sterling Capital Trust IV          | May 2003   | May 2033      | May 2008   | Floating Rate Preferred Securities      | 4.40%                 | 10,310                |
| Sterling Capital Trust III         | April 2003 | April 2033    | April 2008 | Floating Rate Capital Securities        | 4.43%                 | 14,433                |
| Klamath First Capital Trust II     | April 2002 | April 2032    | April 2007 | Floating Rate Capital Securities        | 5.07%                 | 13,464                |
| Klamath First Capital Trust I      | July 2001  | July 2031     | June 2006  | Floating Rate Capital Securities        | 4.96%                 | 15,403                |
| Sterling Capital Trust II          | July 2001  | July 2031     | June 2006  | 10.25% Cumulative Capital Securities    | 10.25%                | 24,743                |
|                                    |            |               |            |   | \$                    | 109,282               |

(4) Sterling has outstanding \$30.0 million of Floating Rate Notes Due 2006. These notes are unsecured general obligations of Sterling and are subordinated to certain other existing and future indebtedness. Under the terms of the notes, Sterling is limited in the amount of certain long-term debt that it may incur, and the notes restrict Sterling, under certain circumstances, as to the amount of cash dividends on its preferred or common stock and capital distributions which can be made. At June 30, 2004, Sterling could have incurred approximately \$164.7 million of additional long-term debt. At June 30, 2004, Sterling could have paid up to approximately \$52.9 million in additional dividends.



Interest accrues at the 90-day LIBOR plus 2.50% (for a total of 4.02% at June 30, 2004) and is adjustable and payable quarterly. The notes mature in 2006 and may be redeemed under certain conditions.

(5) During the quarter ended June 30, 2004 and in 2002, Sterling financed the sale of certain loans to an unrelated party. Since the underlying sold loans were collateral on the loan to the purchaser, these sales were accounted for as financings. At June 30, 2004, \$7.9 million remained outstanding on the financings.

### 3. Earnings Per Share:

The following table presents the basic and diluted earnings per share computations including the effect of the 10% stock dividend, which was paid on May 28, 2004. All per share amounts presented reflect this dividend.

|   |               |                                 | Three Months Ended June 30, |               |                                 |                     |
|---|---------------|---------------------------------|-----------------------------|---------------|---------------------------------|---------------------|
|   | Net<br>Income | 2004<br>Weighted<br>Avg. Shares | Per Share<br>Amount         | Net<br>Income | 2003<br>Weighted<br>Avg. Shares | Per Share<br>Amount |
| Basic computations  | \$ 13,483,000 | 22,589,109                      | \$ 0.60                     | \$ 9,517,000  | 16,248,879                      | \$ 0.59             |
| Effect of dilutive securities:                                  |               |                                 |                             |               |                                 |                     |
| Common stock options  | 0             | 510,944                         | (0.02)                      | 0             | 375,864                         | (0.02)              |
| Diluted computations  | \$ 13,483,000 | 23,100,053                      | \$ 0.58                     | \$ 9,517,000  | 16,624,743                      | \$ 0.57             |
| Antidilutive options not included in diluted earnings per share |               | 11,000                          |                             |               | 0                               |                     |
|   |               |                                 | Six Months Ended June 30,   |               |                                 |                     |
|   | Net<br>Income | 2004<br>Weighted<br>Avg. Shares | Per Share<br>Amount         | Net<br>Income | 2003<br>Weighted<br>Avg. Shares | Per Share<br>Amount |
| Basic computations  | \$ 25,467,000 | 22,471,725                      | \$ 1.13                     | \$ 17,300,000 | 15,668,650                      | \$ 1.10             |
| Effect of dilutive securities:                                  |               |                                 |                             |               |                                 |                     |
| Common stock options  | 0             | 579,801                         | (0.03)                      | 0             | 357,788                         | (0.02)              |
| Diluted computations  | \$ 25,467,000 | 23,051,526                      | \$ 1.10                     | \$ 17,300,000 | 16,026,438                      | \$ 1.08             |
| Antidilutive options not included in diluted earnings per share |               | 11,000                          |                             |               | 0                               |                     |





#### 4. Operating Expenses:

The following table details the components of Sterling's total operating expenses:

|  | Three Months Ended<br>June 30, |           | Six Months Ended<br>June 30, |           |
|--|--------------------------------|-----------|------------------------------|-----------|
|  | 2004                           | 2003      | 2004                         | 2003      |
|  | (Dollars in thousands)         |           |                              |           |
| Employee compensation and benefits             | \$ 19,118                      | \$ 11,997 | \$ 38,324                    | \$ 23,955 |
| Occupancy and equipment                        | 5,929                          | 3,657     | 11,147                       | 7,164     |
| Depreciation                                   | 1,785                          | 1,241     | 3,523                        | 2,401     |
| Amortization of identifiable intangible assets | 555                            | 79        | 1,111                        | 105       |
| Advertising                                    | 1,840                          | 1,689     | 3,707                        | 2,049     |
| Data processing                                | 2,826                          | 1,615     | 4,899                        | 3,226     |
| Insurance                                      | 289                            | 183       | 567                          | 350       |
| Legal and accounting                           | 1,019                          | 409       | 1,598                        | 913       |
| Travel and entertainment                       | 1,073                          | 721       | 1,936                        | 1,259     |
| Goodwill litigation costs                      | 25                             | 64        | 140                          | 314       |
| Merger and acquisition costs                   | 922                            | 45        | 4,835                        | 188       |
| Other  | 1,707                          | 904       | 3,020                        | 2,091     |
| Total operating expenses                       | \$ 37,088                      | \$ 22,604 | \$ 74,807                    | \$ 44,015 |

#### 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 and Montana primarily through 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 and Arizona primarily through INTERVEST-Mortgage Investment Company.

The Insurance and Retail Brokerage segment markets fixed income and equity products, mutual funds, fixed and variable annuities, insurance and other financial products through sales representatives within the Sterling Savings

Bank branch network primarily through Harbor Financial Services, Inc.

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

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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, 2004 |                        |                                    |                                   |                     |                           |              |
|--|------------------------|------------------------------------|-----------------------------------|---------------------|---------------------------|--------------|
|  | Community<br>Banking   | Residential<br>Mortgage<br>Banking | Commercial<br>Mortgage<br>Banking | Retail<br>Brokerage | Other and<br>Eliminations | Total        |
|  | (Dollars in thousands) |                                    |                                   |                     |                           |              |
| Interest income                                    | \$ 73,094              | \$ 2,253                           | \$ 1,666                          | \$ 0                | \$ 227                    | \$ 77,240    |
| Interest expense                                   | 26,521                 | 0                                  | 0                                 | 0                   | 1,995                     | 28,516       |
| Net interest income<br>(expense)                   | 46,573                 | 2,253                              | 1,666                             | 0                   | (1,768)                   | 48,724       |
| Provision for loan<br>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<br>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 Three Months Ended June 30, 2003 |                        |                                    |                                   |                     |                           |              |
|--|------------------------|------------------------------------|-----------------------------------|---------------------|---------------------------|--------------|
|  | Community<br>Banking   | Residential<br>Mortgage<br>Banking | Commercial<br>Mortgage<br>Banking | Retail<br>Brokerage | Other and<br>Eliminations | Total        |
|  | (Dollars in thousands) |                                    |                                   |                     |                           |              |
| Interest income                                    | \$ 48,964              | \$ 2,258                           | \$ 1,428                          | \$ 1                | \$ 0                      | \$ 52,651    |
| Interest expense                                   | 20,697                 | 0                                  | 0                                 | 0                   | 1,914                     | 22,611       |
| Net interest income<br>(expense)                   | 28,267                 | 2,258                              | 1,428                             | 1                   | (1,914)                   | 30,040       |
| Provision for loan<br>losses                       | (2,550)                | 0                                  | 0                                 | 0                   | 0                         | (2,550)      |
| Noninterest income                                 | 10,462                 | 2,523                              | 618                               | 508                 | (4,422)                   | 9,689        |
| Noninterest expense                                | 19,263                 | 2,550                              | 620                               | 399                 | (228)                     | 22,604       |
| Income before income<br>taxes                      | \$ 16,916              | \$ 2,231                           | \$ 1,426                          | \$ 110              | \$ (6,108)                | \$ 14,575    |
| Total assets                                       | \$ 4,135,402           | \$ 19,211                          | \$ 13,298                         | \$ 1,417            | \$ (72,326)               | \$ 4,097,002 |

## As of and for the Six Months Ended June 30, 2004

|                                  | Community<br>Banking | Residential<br>Mortgage<br>Banking | Commercial<br>Mortgage<br>Banking<br>(Dollars in thousands) | Retail<br>Brokerage | Other and<br>Eliminations | Total        |
|----------------------------------|----------------------|------------------------------------|---|---------------------|---------------------------|--------------|
| 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<br>(expense) | 90,256               | 4,282                              | 3,413   | 1                   | (3,539)                   | 94,413       |
| Provision for loan<br>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<br>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 |

## As of and for the Six Months Ended June 30, 2003

|                                  | Community<br>Banking | Residential<br>Mortgage<br>Banking | Commercial<br>Mortgage<br>Banking<br>(Dollars in thousands) | Retail<br>Brokerage | Other and<br>Eliminations | Total        |
|----------------------------------|----------------------|------------------------------------|---|---------------------|---------------------------|--------------|
| Interest income                  | \$ 96,969            | \$ 4,309                           | \$ 2,857  | \$ 1                | \$ 0                      | \$ 104,136   |
| Interest expense                 | 41,514               | 0                                  | 0   | 0                   | 4,011                     | 45,525       |
| Net interest income<br>(expense) | 55,455               | 4,309                              | 2,857   | 1                   | (4,011)                   | 58,611       |
| Provision for loan<br>losses     | (4,800)              | 0                                  | 0   | 0                   | 0                         | (4,800)      |
| Noninterest income               | 19,972               | 5,135                              | 606   | 966                 | (9,881)                   | 16,798       |
| Noninterest expense              | 37,730               | 4,650                              | 1,363   | 725                 | (453)                     | 44,015       |
| Income before income<br>taxes    | \$ 32,897            | \$ 4,794                           | \$ 2,100  | \$ 242              | \$ (13,439)               | \$ 26,594    |
| Total assets                     | \$ 4,135,402         | \$ 19,211                          | \$ 13,298   | \$ 1,417            | \$ (72,326)               | \$ 4,097,002 |

## 6. Stock Options:

As allowed by SFAS No. 123, Accounting for Stock-Based Compensation ( SFAS No. 123 ), Sterling has elected to retain the compensation measurement principles of APB 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. The measurement date is the date at which both the number of options and the exercise price for each option are known.

Sterling has chosen not to record compensation expense using fair value measurement provisions in the statement of income. 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<br>June 30,                   |          | Six Months Ended<br>June 30, |           |
|---|--|----------|------------------------------|-----------|
|   | 2004   | 2003     | 2004                         | 2003      |
|   | (Dollars in thousands, except per share amounts) |          |                              |           |
| Reported net income   | \$ 13,483  | \$ 9,517 | \$ 25,467                    | \$ 17,300 |
| Add back: Stock-based employee compensation expense,<br>net of related tax effects  | 0  | 0        | 0                            | 0         |
| Deduct: Total stock-based employee compensation expense<br>determined under fair value based method for all awards,<br>net of related tax effects | (1,009)  | (548)    | (2,018)                      | (1,097)   |
| Pro forma   | \$ 12,474  | \$ 8,969 | \$ 23,449                    | \$ 16,203 |
| Basic earnings per share:   |  |          |                              |           |
| Reported earnings per share   | \$ 0.60  | \$ 0.59  | \$ 1.13                      | \$ 1.10   |
| Stock-based employee compensation, fair value   | (0.05)   | (0.04)   | (0.09)                       | (0.07)    |
| Pro forma earnings per share  | \$ 0.55  | \$ 0.55  | \$ 1.04                      | \$ 1.03   |
| Diluted earnings per share:   |  |          |                              |           |
| Reported earnings per share   | \$ 0.58  | \$ 0.57  | \$ 1.10                      | \$ 1.08   |
| Stock-based employee compensation, fair value   | (0.04)   | (0.03)   | (0.08)                       | (0.07)    |
| Pro forma earnings per share  | \$ 0.54  | \$ 0.54  | \$ 1.02                      | \$ 1.01   |

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions used for grants in the periods above: dividend yield of 0% in each period, expected stock price volatility of 85% to 132% during each period, risk-free interest rates of 2.86% to 6.52% and expected lives of four to ten years, respectively.

## 7. New Accounting Policies:

In December 2003, the Financial Accounting Standards Board ( FASB ) issued FIN No. 46R, which provides further guidance on the accounting for variable interest entities. Sterling adopted FIN No. 46R as of December 31, 2003 and Sterling has applied the provisions of FIN No. 46R beginning in the first quarter of 2004 by deconsolidating its subsidiary statutory trusts that issue Trust Preferred Securities to investors. The amounts payable to these trusts continue to be treated as other borrowings. The adoption of FIN No. 46R did not have a material effect on Sterling's consolidated financial statements.



In December 2003, the American Institute of Certified Public Accountants issued Statement of Position ( SOP ) No. 03-3, Accounting for Certain Loans or Debt Securities Acquired in a Transfer. 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. Sterling believes the implementation of SOP No. 03-3 will not have a material effect on its 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 mandatory forward sales agreements on ABS 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 ABS to the counterparty on the agreed terms. Action Mortgage could incur significant costs in acquiring replacement loans or ABS 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 are considered to be derivatives. Sterling has recorded the estimated fair values of 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 net gain on sales of mortgage loans in the income statement as the changes occur. The estimated fair value of rate locks was an asset of \$357,356 and the estimated fair value of forward sales agreements was a liability of \$195,469 at June 30, 2004.

**9. Business Combinations:**

On January 2, 2004, Klamath First Bancorp, Inc. ( Klamath ), an Oregon corporation, was merged with and into Sterling, with Sterling being the surviving corporation in the merger. Klamath's wholly owned subsidiary, Klamath First Federal Savings and Loan Association, was merged with and into Sterling's wholly-owned subsidiary, Sterling Savings Bank, with Sterling Savings Bank being the surviving institution.

**10. Stock Dividend:**

On May 28, 2004, Sterling paid a 10% stock dividend. Accordingly, all weighted average shares outstanding and per share amounts have been restated to reflect this common stock dividend.

**11. Subsequent Event:**

In July 2004, Sterling sold substantially all the assets of The Dime Service Corporation ( Dime ) and exited the property and casualty insurance business. The assets and liabilities of Dime were not material to the consolidated financial statements and there was no material gain or loss recorded on the sale.





**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, 2004 and 2003**

*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 2003 annual report on Form 10-K.*

**General**

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

Sterling provides personalized, quality financial services to its customers as exemplified by its Hometown Helpful philosophy. 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 \$6.26 billion in total assets at June 30, 2004, Sterling attracts Federal Deposit Insurance Corporation ( FDIC ) insured deposits from the general public through 135 retail branches located in Washington, Oregon, Idaho and Montana. Sterling originates loans through its branch offices, including nine in-store branches, as well as Action Mortgage residential loan production offices in the four-state area and through INTERVEST commercial real estate lending offices in Washington, Oregon and Arizona. Sterling also markets fixed income and equity products, mutual funds, fixed and variable annuities and many other financial products through Harbor Financial.

Sterling continues to enhance its presence as a leading community bank by increasing its commercial real estate, business banking, consumer and construction lending while 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 liabilities) 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 asset-backed securities ( ABS ), fees and service charges and mortgage banking operations. The operations of Sterling Savings Bank, and savings institutions generally, are influenced significantly by general economic conditions and by policies of its primary regulatory authorities, the Office of Thrift Supervision ( OTS ), the FDIC and the State of Washington Department of Financial Institutions ( Washington Supervisor ).

**Executive Summary and Highlights**

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Net income for the three months ended June 30, 2004 increased 42% to \$13.5 million, or \$0.58 per diluted share, compared with net income of \$9.5 million, or \$0.57 per diluted share, for last year's comparable period. Net income for the six months ended June 30, 2004 increased 47% to \$25.5 million, or \$1.10 per diluted share, compared with net income of \$17.3 million, or \$1.08 per diluted share, for last year's comparable period. The increase in earnings primarily reflected continued increases in NII and other income that were primarily due to the recent merger (the Merger) with Klamath First Bancorp, Inc. (Klamath).

Other highlights for the quarter ended June 30, 2004 are as follows:

Earnings per diluted share were \$0.58 for the quarter ended June 30, 2004, compared to \$0.57 per diluted share for the same period in 2003.

NII increased 62% over the second quarter of 2003.

Total loan originations increased to a record \$786.4 million for the three months ended June 30, 2004, a 19% increase over the second quarter of 2003.

Nonperforming assets to total assets decreased to 27 basis points from 77 basis points at June 30, 2003.

Sterling paid a 10% stock dividend effective May 28, 2004.

### **Company Growth**

In January 2004, Klamath was merged with and into Sterling, with Sterling being the surviving corporation in the merger. Klamath's wholly owned subsidiary, Klamath First Federal Savings and Loan Association, was merged with and into Sterling's wholly-owned subsidiary, Sterling Savings Bank, with Sterling Savings Bank being the surviving institution.

Under the terms of the Merger, each share of Klamath common stock was converted into 0.77 shares of Sterling common stock. Sterling issued 5,431,067 shares of common stock in exchange for all of the stock of Klamath. As a result of the Merger, Sterling acquired approximately \$988 million in deposits, \$778 million in investments and ABS, \$564 million in loans and \$145 million in capital, while adding approximately 450 employees to its work force. In addition, Sterling added 48 retail branches and significantly increased its deposit market share in Oregon from 0.5% to over 4.0%. See Note 9 of Notes to Consolidated Financial Statements.

With this expanded branch network, Sterling has strengthened its position as a leading regional community bank. This merger is consistent with Sterling's strategy to become the leading community bank in the Pacific Northwest. Klamath's strong deposit base has complemented Sterling's asset growth strategy, while the combined branch network and access to capital have given Sterling the opportunity to continue its growth in the region.

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 are based upon past loss experience, trends in losses and delinquencies, the growth of loans in particular markets and industries, and known changes in economic conditions in the particular lending markets. 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.

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, 2004. 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.

**Investments and ABS.** Assets in the investment and ABS 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.

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 and the write down will be deducted from earnings under realized losses. There were no investment securities which management identified to be other-than-temporarily impaired for the three and six months ended June 30, 2004. Charges to income 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, 2004, 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.** Property acquired through foreclosure of defaulted mortgage loans is carried at the lower of cost or fair value less estimated costs to sell. Development and improvement costs relating to the property are capitalized to the extent they are deemed to be recoverable.

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

## Results of Operations

**Overview.** Sterling recorded net income of \$13.5 million, or \$0.58 per diluted share, for the three months ended June 30, 2004, compared with net income of \$9.5 million, or \$0.57 per diluted share, for the three months ended June 30, 2003. Sterling recorded net income of \$25.5 million, or \$1.10 per diluted share, for the six months ended



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June 30, 2004, compared with \$17.3 million, or \$1.08 per diluted share, for the six months ended June 30, 2003. The increases in net income for both periods reflect an increase in NII and other income.

The annualized return on average assets ( ROA ) was 0.86% and 0.98% for the three months ended June 30, 2004 and 2003, respectively, while ROA was 0.84% and 0.92% for the six months ended June 30, 2004 and 2003, respectively. The annualized return on average equity ( ROE ) was 12.4% and 15.5% for the three months ended June 30, 2004 and 2003, respectively. ROE was 12.2% and 15.0% for the six months ended June 30, 2004 and 2003, respectively. The decreases in ROA primarily reflected a higher balance of average assets relative to last

year's comparable period. The decreases in ROE were primarily due to the increase in shareholder's equity. The lower-yielding assets acquired in the Merger also decreased Sterling's ROA and ROE.

**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, ABS and investment portfolios, and interest expense, primarily on deposits and borrowings. During the three months ended June 30, 2004 and 2003, NII was \$48.7 million and \$30.0 million, respectively, an increase of 62%. For the six months ended June 30, 2004 and 2003, NII was \$94.4 million and \$58.6 million, an increase of 61%. The increase in NII during the three and six months ended June 30, 2004, compared to the same periods in 2003, was primarily due to the increases in average loan and ABS volumes following the Merger and a decrease in the cost of deposits and borrowings.

Changes in NII result from changes in volume, net interest spread and net interest margin. 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 interest-earning assets and is influenced by the level and relative mix of interest-earning assets and interest-bearing liabilities.

Average interest-earning assets for the three months ended June 30, 2004 and 2003 were \$5.77 billion and \$3.64 billion, respectively. Average loans increased by \$1.05 billion, while average investments and ABS increased by \$1.08 billion over the 2003 amounts. Net interest spread during these periods was 3.37% and 3.26%, respectively. Net interest margin for the three months ended June 30, 2004 and 2003 was 3.40% and 3.31%, respectively. Net interest spread increased due to a greater decrease in the cost of funds relative to the yield on average interest-earning assets. The increase in the net interest margin reflected a greater volume of average earning assets compared to the second quarter of 2003.

Average interest-earning assets for the six months ended June 30, 2004 and 2003 were \$5.64 billion and \$3.55 billion, respectively. Average loans increased by \$1.06 billion, while average investments and ABS increased by \$1.03 billion over the prior comparable period. Net interest spread for the six months ended June 30, 2004 and 2003 was 3.35% and 3.29%, respectively, while the net interest margin for the same periods was 3.36% and 3.33%, respectively. The increase in the net interest spread during the six months ended June 30, 2004 was due to the same factors that influenced the three month change. The increase in the net interest margin for the six month period reflected a higher average volume of loans and ABS, generating the increase in NII, thereby increasing the margin compared to the same period in 2003. However, Sterling acquired lower-yielding loans and securities from the Merger that partially offset the increase in the ratios during the first six months of 2004.

**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.

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Sterling recorded provisions for losses on loans of \$3.0 million and \$2.6 million for the three months ended June 30, 2004 and 2003, respectively. Sterling recorded provisions for losses on loans of \$5.9 million and \$4.8 million for the six months ended June 30, 2004 and 2003, 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 which have a somewhat higher loss profile than the traditional thrift institution mix of loans.

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

|   | Six Months Ended June 30, |           |
|---|---------------------------|-----------|
|   | 2004                      | 2003      |
|   | (Dollars in thousands)    |           |
| Balance at January 1                            | \$ 35,605                 | \$ 27,866 |
| Allowance for loan losses acquired              | 6,722                     | 869       |
| Provision for losses on loans                   | 5,850                     | 4,800     |
| Amounts written off net of recoveries and other | (2,926)                   | (1,501)   |
| Balance at June 30                              | \$ 45,251                 | \$ 32,034 |

At June 30, 2004, Sterling's total classified assets were 1.29% of total assets, compared with 1.96% of total assets at June 30, 2003. Nonperforming assets were 0.27% of total assets at June 30, 2004, compared with 0.77% of total assets at June 30, 2003. The decreases in classified and nonperforming assets primarily reflected the sale of certain real estate owned properties, as well as improvements in the status of certain business banking, commercial real estate and construction loans. Sterling does not anticipate significant losses in these classified assets, although there can be no assurances in this regard. At June 30, 2004, the loan delinquency ratio was 0.43% of total loans compared to 1.13% of total loans at June 30, 2003. The decrease in the ratio primarily reflected lower volumes of delinquent consumer and commercial real estate loans.

**Other Income.** Other income was \$11.8 million and \$9.7 million for the three months ended June 30, 2004 and 2003, respectively. Other income was \$24.7 million and \$16.8 million for the six months ended June 30, 2004 and 2003, respectively. The increase was primarily due to an increase in fees and service charges.

Fees and service charge income increased by 72% to \$8.4 million for the three months ended June 30, 2004 from \$4.9 million for the same period last year. For the six months ended June 30, 2004 and 2003, fees and service charge income increased by 82%, or \$7.5 million. This increase was primarily due to an increase in the number of transaction accounts, fees for new overdraft protection services and strong growth in the number of transaction accounts. Sterling had 145,641 transaction accounts at June 30, 2004, an increase of 61,713 accounts from June 30, 2003. Most of this increase was from accounts acquired in the Merger.

The following table summarizes loan originations, sales of loans and the balance of serviced mortgage loans for the periods indicated:

|  | Three Months Ended<br>June 30, |          | Six Months Ended<br>June 30, |          |
|--|--------------------------------|----------|------------------------------|----------|
|  | 2004                           | 2003     | 2004                         | 2003     |
|  | (Dollars in millions)          |          |                              |          |
| Originations of one- to four-family permanent mortgage loans           | \$ 91.9                        | \$ 146.4 | \$ 162.7                     | \$ 278.7 |
| Sales of residential loans   | 55.0                           | 92.8     | 82.3                         | 188.1    |
| Principal balances of residential loans serviced for others            | 206.3                          | 213.5    | 206.3                        | 213.5    |
| Principal balances of commercial real estate loans serviced for others | 291.0                          | 196.5    | 291.0                        | 196.5    |

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Mortgage banking operations ( MBO ) income was \$1.8 million and \$2.5 million, respectively, for the three months ended June 30, 2004 and 2003, respectively. MBO income was \$3.0 million and \$4.7 million for the six months ended June 30, 2004 and 2003, respectively. The decrease primarily reflected an industry wide slow-down in residential refinancing activity. Increased revenues from Sterling s commercial mortgage banking segment partially offset the decreases in the residential mortgage banking segment, particularly in the June 2004 quarter. During the quarter ended June 30, 2004, the commercial mortgage banking segment provided 34% of total MBO income, as compared with 13% for the March 2004 quarter.

During the quarter ended June 30, 2004, Sterling sold \$77.4 million in investments and ABS, compared with \$373.5 million for the quarter ended June 30, 2003. Sterling recognized a net gain of \$0.8 million and \$1.7 million for the three months ended June 30, 2004 and 2003, respectively. During the six months ended June 30, 2004, Sterling sold \$344.2 million in investments and ABS compared with \$588.8 million for the same period in 2003. Sterling recognized a net gain of \$3.3 million and \$3.0 million for the six months ended June 30, 2004 and 2003, respectively. The decrease in net gains on sales of investments and ABS for the three months ended June 30, 2004 compared to the prior year's comparable period primarily reflected the decrease in the volume of sales of investments and ABS.

**Operating Expenses.** Operating expenses were \$37.1 million and \$22.6 million for the three months ended June 30, 2004 and 2003, respectively. Operating expenses were \$74.8 million and \$44.0 million for the six months ended June 30, 2004 and 2003, respectively. The higher level of operating expenses was primarily due to increases in personnel, occupancy, and data processing expenses and merger and acquisition costs.

Employee compensation and benefits were \$19.1 million and \$12.0 million for the three months ended June 30, 2004 and 2003, respectively. Employee compensation and benefits were \$38.3 million and \$24.0 million for the six months ended June 30, 2004 and 2003, respectively. Full-time equivalent employees have increased year-over-year to 1,552 full-time equivalents at June 30, 2004, an increase of 494 full-time equivalents. The majority of this year-over-year increase can be attributed to the personnel acquired in the Merger.

Occupancy and equipment expenses were \$5.9 million and \$3.7 million for the three months ended June 30, 2004 and 2003, respectively. Occupancy and equipment expenses were \$11.1 million and \$7.2 million for the six months ended June 30, 2004 and 2003, respectively. The increase for the period reflected higher costs related to additional occupied space and additional staff equipment costs associated with Sterling's acquisition of 48 additional branch locations as a result of the Merger.

Data processing expenses were \$2.8 million and \$1.6 million for the three months ended June 30, 2004 and 2003, respectively. Data processing expenses were \$4.9 million and \$3.2 million for the six months ended June 30, 2004 and 2003, respectively. The increases for both periods reflected the increase in data processing volume due to increases in the number of transactions, deposits and employees as a result of the Merger.

Merger and acquisition costs were \$922,000 and \$45,000 for the three months ended June 30, 2004 and 2003, respectively. Merger and acquisition costs were \$4.8 million and \$188,000 for the six months ended June 30, 2004 and 2003, respectively. The increase in merger and acquisition costs for the six month period resulted from the Merger. Management does not anticipate material costs associated with the Merger for the remainder of the year.

**Income Tax Provision.** Sterling recorded federal and state income tax provisions of \$7.0 million and \$5.1 million for the three months ended June 30, 2004 and 2003, respectively. For the six months ended June 30, 2004 and 2003, Sterling recorded federal and state income tax provisions of \$13.0 million and \$9.3 million, respectively. The effective tax rates for the three month periods were 34.1% and 34.7%, respectively. The effective tax rates for the six month periods were 33.8% and 34.9%, respectively. The decrease in the effective tax rates compared to the periods ended June 30, 2003 were primarily due to the effect of tax credits for investments in certain low income housing developments.



## Financial Position

**Assets.** At June 30, 2004, Sterling's assets were \$6.26 billion, up 46% from \$4.28 billion at December 31, 2003. For a discussion of the impact of the Merger on Sterling's consolidated total assets, see Company Growth.

**Investments and ABS.** Sterling's investment and ABS portfolio at June 30, 2004 was \$2.0 billion, an increase of \$944.3 million from the December 31, 2003 balance of \$1.07 billion. The increase was primarily due to approximately \$778 million of investments and ABS acquired from the Merger.

**Loans Receivable.** At June 30, 2004, net loans receivable were \$3.72 billion, up \$815.6 million from \$2.91 billion at December 31, 2003. The increase was primarily due to approximately \$564 million of loans acquired from the Merger, as well as increased loan originations during the most recent quarter. During the three months ended June 30, 2004, total loan originations were \$786.4 million compared with \$658.8 million for the prior year's comparable period. During the six months ended June 30, 2004, total loan originations were \$1.38 billion compared with \$1.14 billion for the prior year's comparable period. The quarter-over-quarter and year-over-year increases in loan originations were mainly influenced by strong consumer-direct, corporate and business banking lending. These increases were partially offset by a continued decrease in residential real estate loan originations.

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

|   | June 30, 2004 |       | December 31, 2003 |       |
|---|---------------|-------|-------------------|-------|
|   | Amount        | %     | Amount            | %     |
| (Dollars in thousands)                  |               |       |                   |       |
| Residential real estate                 | \$ 566,218    | 15.0  | \$ 407,999        | 13.8  |
| Multifamily real estate                 | 185,487       | 4.9   | 167,220           | 5.7   |
| Commercial real estate                  | 628,500       | 16.6  | 463,191           | 15.7  |
| Real estate construction                | 572,468       | 15.2  | 552,965           | 18.7  |
| Consumer - direct                       | 510,362       | 13.5  | 309,931           | 10.5  |
| Consumer - indirect                     | 106,503       | 2.8   | 99,697            | 3.4   |
| Business and private banking            | 875,699       | 23.2  | 720,071           | 24.4  |
| Corporate banking                       | 330,540       | 8.8   | 228,233           | 7.8   |
| Gross loans receivable                  | 3,775,777     | 100.0 | 2,949,307         | 100.0 |
| Net deferred origination fees           | (8,535)       |       | (7,276)           |       |
| Allowance for losses on loans           | (45,251)      |       | (35,605)          |       |
| Loans receivable, net                   | \$ 3,721,991  |       | \$ 2,906,426      |       |
| Weighted average yield at end of period | 5.93%         |       | 5.71%             |       |





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

|                              | Three Months Ended |                   |                        | Six Months Ended |                  |          |
|------------------------------|--------------------|-------------------|------------------------|------------------|------------------|----------|
|                              | 2004               | June 30,<br>2003e | % Chang                | 2004             | June 30,<br>2003 | % Change |
|                              |                    |                   | (Dollars in thousands) |                  |                  |          |
| Residential real estate      | \$ 91,948          | \$ 146,405        | (37.2)                 | \$ 162,677       | \$ 278,693       | (41.6)   |
| Multifamily real estate      | 21,080             | 17,077            | 23.4                   | 36,417           | 30,442           | 19.6     |
| Commercial real estate       | 37,755             | 48,304            | (21.8)                 | 98,515           | 85,403           | 15.4     |
| Real estate construction     | 213,079            | 195,137           | 9.2                    | 388,591          | 324,291          | 19.8     |
| Consumer - direct            | 127,792            | 61,632            | 107.3                  | 195,924          | 93,940           | 108.6    |
| Consumer - indirect          | 11,512             | 15,594            | (26.2)                 | 24,419           | 29,862           | (18.2)   |
| Business and private banking | 122,621            | 122,857           | (0.2)                  | 265,974          | 197,443          | 34.7     |
| Corporate banking            | 160,576            | 51,780            | 210.1                  | 203,816          | 98,630           | 106.7    |
| Total loans originated       | \$ 786,363         | \$ 658,786        | 19.4                   | \$ 1,376,333     | \$ 1,138,704     | 20.9     |

**BOLI.** Bank-owned life insurance ( BOLI ) increased to \$91.7 million at June 30, 2004 from \$73.1 million at December 31, 2003. The increase was primarily due to the \$16.3 million in BOLI acquired in the Merger. Sterling maintains BOLI to fund employee benefit costs. Through the purchase of BOLI, Sterling becomes the beneficiary of life insurance policies on certain individuals who consent to the issuance of the policies.

**Goodwill and Other Intangible Assets.** Goodwill and other intangible assets increased to \$149.1 million at June 30, 2004 from \$48.0 million at December 31, 2003. In January 2004, Sterling recorded \$83.2 million in goodwill and \$19.2 million in other intangible assets in connection with the Merger.

**Deposits.** Total deposits increased \$1.15 billion to \$3.60 billion at June 30, 2004 from \$2.46 billion at December 31, 2003, primarily due to the acquisition of approximately \$988 million in deposits from the Merger. See Company Growth.

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

|                          | June 30, 2004 |                        | December 31, 2003 |      |
|--------------------------|---------------|------------------------|-------------------|------|
|                          | Amount        | %                      | Amount            | %    |
|                          |               | (Dollars in thousands) |                   |      |
| Noninterest checking     | \$ 525,329    | 14.6                   | \$ 306,456        | 12.5 |
| NOW checking             | 401,066       | 11.1                   | 301,197           | 12.3 |
| Savings and money market | 1,095,266     | 30.4                   | 663,858           | 27.0 |
| Time deposits            | 1,579,038     | 43.9                   | 1,183,565         | 48.2 |

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|                             |    |           |       |    |           |       |
|-----------------------------|----|-----------|-------|----|-----------|-------|
| Total deposits              | \$ | 3,600,699 | 100.0 | \$ | 2,455,076 | 100.0 |
| Annualized cost of deposits |    |           | 1.40% |    |           | 1.58% |

**Borrowings.** Deposit accounts are Sterling's primary source of funds. Sterling does, however, rely upon advances from the Federal Home Loan Bank of Seattle ( FHLB Seattle ), reverse repurchase agreements and other borrowings to supplement its funding and to meet deposit withdrawal requirements. At June 30, 2004, the total of such borrowings was \$2.16 billion compared with \$1.53 billion at December 31, 2003. 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 adjustable rate mortgages are indexed to the one-year or five-year U.S. Treasury index or periodic fixed-rate 30-day London Interbank Offering 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 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.

The calculations of present value have certain shortcomings. The discount rates utilized for loans, investments and ABS 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 ABS 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 interest rate risk ( IRR ) as presented in the following table 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 continues to manage the level of its IRR while increasing its NII and NPV. Sterling's strategy includes: a) originating and retaining variable-rate consumer, business banking, construction and commercial real estate loans, which generally have higher yields than residential permanent loans; b) utilizing the cash flows from the ABS portfolio to fund loan originations; c) selling certain long-term, fixed-rate loans and investments; and d) increasing the level of core deposits, which generally are a lower-cost funding source than wholesale borrowings. Additionally, over 50% of Sterling's loan portfolio will reprice or mature over the next 12 months. 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 presents Sterling's estimates of changes in NPV for the periods indicated. 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, 2004 |   |  | At December 31, 2003 |   |                 |
|--|------------------|---|--|----------------------|---|-----------------|
|  | NPV              | Ratio of NPV to the Present Value of Total Assets | % Change in NPV (Dollars in thousands) | NPV                  | Ratio of NPV to the Present Value of Total Assets | % Change in NPV |
| +300   | \$364,567        | 5.95%   | (28.7)                                 | \$232,820            | 5.10%   | (23.3)          |
| +200   | 415,980          | 6.69  | (18.7)                                 | 260,054              | 5.66  | (14.3)          |
| +100   | 467,203          | 7.40  | (8.7)                                  | 285,298              | 6.09  | (6.0)           |
| Static   | 511,633          | 7.99  | 0.0                                    | 303,395              | 6.44  | 0.0             |
| -100   | 501,476          | 7.79  | (2.0)                                  | 270,817              | 5.19  | (10.8)          |
| -200   | N/A(1)           | N/A(1)  | N/A(1)                                 | N/A(1)               | N/A(1)  | N/A(1)          |
| -300   | N/A(1)           | N/A(1)  | N/A(1)                                 | N/A(1)               | N/A(1)  | N/A(1)          |

(1) In low interest rate environments, the calculations are not relatively meaningful.

Sterling also uses gap analysis, a traditional analytical tool designed to measure the difference between the amount of interest-earning assets and the amount of interest-bearing liabilities expected to mature or reprice in a given period. Sterling calculated its one-year cumulative gap position to be a negative 10.7% and a negative 6.1% at June 30, 2004 and December 31, 2003, respectively. Sterling calculated its three-year gap position to be a negative 3.4% and a negative 1.0% at June 30, 2004 and December 31, 2003, respectively. The change in both gap positions was primarily due to the duration of interest-earning assets and interest-bearing liabilities acquired from the Merger. Management attempts to maintain Sterling's gap position between positive 10% and negative 25%. At June 30, 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

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increased 47% to \$3.60 billion at June 30, 2004 from \$2.46 billion at December 31, 2003, primarily due to the acquisition of approximately \$988 million in deposits from the Merger and to additional increases in transaction deposits.

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, 2004, cash used in investing activities consisted primarily of the amounts used to fund loans and purchase investments and ABS. Sterling acquired approximately \$45 million of cash and cash equivalents as a result of the Merger. During this period, net cash provided by financing activities was \$407.8 million, which consisted primarily of \$97.6 million in deposits and \$296.1 million in additional reverse repurchase agreements used to supplement other funding sources.

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, 2004, this credit line represented a total borrowing capacity of \$2.16 billion, of which \$153.7 million was available. Sterling Savings Bank also borrows funds under reverse repurchase agreements pursuant to which it sells investments (generally U.S. agency securities and ABS) 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 ABS sold. Sterling Savings Bank uses these borrowings to supplement deposit gathering for funding the origination of loans. At June 30, 2004, Sterling Savings Bank had \$659.3 million in outstanding borrowings under reverse repurchase agreements and had securities available for additional secured borrowings of approximately \$284.7 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 and other resources of approximately \$30.5 million and a revolving line of credit from U.S. Bank of \$5.0 million at June 30, 2004 with no funds drawn on this line of credit. This line of credit as well as a \$22.0 million term note are secured by a majority of the Common and Preferred Stock of Sterling Savings Bank. See Note 2 of Notes to Consolidated Financial Statements.

At June 30, 2004 and 2003, Sterling had an investment of \$110.1 million in the Preferred Stock of Sterling Savings Bank. At June 30, 2004 and 2003, Sterling had an investment in the Common Stock of Sterling Savings Bank of \$295.0 million and \$132.6 million, respectively. Sterling received cash dividends on Sterling Savings Bank Preferred Stock of \$968,000 during the six months ended June 30, 2004. 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 rules and regulations imposed by the OTS. See Note 2 of Notes to Consolidated Financial Statements.



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

The following table represents Sterling's on-and-off balance sheet aggregate contractual obligations to make future payments as of June 30, 2004:

|  | Total      | Payments Due by Period |  |                      |                      |
|--|------------|------------------------|--|----------------------|----------------------|
|  |            | Less than<br>1 year    | 1 to 3 years<br>(Dollars in thousands) | Over<br>3 to 5 years | More than<br>5 years |
| Long-term debt(1)  | \$ 158,000 | \$ 3,000               | \$ 36,000                              | \$ 6,000             | \$ 113,000           |
| Capital lease obligations  | 0          | 0                      | 0                                      | 0                    | 0                    |
| Operating leases   | 18,135     | 2,519                  | 9,251                                  | 3,598                | 2,767                |
| Purchase obligations(2)  | 2,826      | 2,826                  | 0                                      | 0                    | 0                    |
| Other long-term liabilities<br>reflected on the registrant's<br>balance sheet under GAAP | 0          | 0                      | 0                                      | 0                    | 0                    |
| Total  | \$ 178,961 | \$ 8,345               | \$ 45,251                              | \$ 9,598             | \$ 115,767           |

(1) Excludes interest payments. See Note 2 of Notes to Consolidated Financial Statements.

(2) Excludes recurring accounts payable amounts due in the third quarter of 2004.

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 ABS 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 ABS to the counterparty on the agreed terms. Action Mortgage could incur significant costs in acquiring replacement loans or ABS 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 are considered to be derivatives. Sterling has recorded the estimated fair values of 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

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net gain on sales of mortgage loans in the income statement as the changes occur. The estimated fair value of rate locks was an asset of \$357,356 and the estimated fair value of forward sales agreements was a liability of \$195,469 at June 30, 2004.

## Capital

Sterling's total shareholders' equity was \$408.2 million at June 30, 2004 compared with \$250.3 million at December 31, 2003. The increase in total shareholders' equity was primarily due to the issuance of shares in connection with the Merger and the increase in net income. Sterling acquired approximately \$145 million of capital in connection with the Merger. Shareholders' equity was 6.5% of total assets at June 30, 2004 compared with 5.9% at December 31, 2003.

At June 30, 2004, Sterling had an unrealized loss of \$31.3 million, net of related income taxes, on investments and ABS classified as available for sale. At December 31, 2003, Sterling had an unrealized loss of \$15.2 million, net of related income taxes, on investments and ABS classified as available for sale. The change since December 31, 2003 reflected the decrease in the market value of the ABS portfolio, which was primarily caused by the increase in long-term interest rates. 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, is not subject to the Federal Reserve capital requirements for bank holding companies, the Trust Preferred Securities have been 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 Note 2 of Notes to Consolidated Financial Statements.

Sterling has a variable-rate term note with U.S. Bank with a balance of \$22.0 million outstanding at June 30, 2004. This note matures on September 17, 2007. Interest accrues at the 30-day LIBOR plus 2.00% and is payable monthly. Sterling also has a \$5.0 million revolving line of credit with U.S. Bank. This line of credit expires on September 15, 2004. The interest rate is adjustable monthly at the 30-day LIBOR plus 2.00% and is payable monthly. At June 30, 2004, no amounts were outstanding on the line of credit. The term note and line of credit are collateralized by a majority of the Common and Preferred Stock of Sterling Savings Bank. See Note 2 of Notes to Consolidated Financial Statements.

Sterling's \$30.0 million of Floating Rate Notes Due 2006 were designed to be treated as Tier 2 capital, subject to certain limitations, if Sterling were to become regulated as a bank holding company. See Note 2 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, 2004, Sterling Savings Bank exceeded all such regulatory capital requirements and was well-capitalized pursuant to OTS regulations.

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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, 2004:

|  | Minimum Capital Requirements |       | Well-Capitalized Requirements    |        | Actual     |        |
|--|------------------------------|-------|----------------------------------|--------|------------|--------|
|  | Amount                       | Ratio | Amount<br>(Dollars in thousands) | Ratio  | Amount     | Ratio  |
| Total risk-based capital (to risk-weighted assets)         | \$ 333,839                   | 8.00% | \$ 417,299                       | 10.00% | \$ 453,089 | 10.86% |
| Core (Tier 1) risk-based capital (to risk-weighted assets) | 166,919                      | 4.00  | 250,379                          | 6.00   | 410,483    | 9.84   |
| Core (Tier 1) capital (to adjusted assets)                 | 245,387                      | 4.00  | 306,734                          | 5.00   | 410,483    | 6.69   |

### Goodwill Litigation

In contracts made in connection with Sterling Savings Bank's acquisition of three insolvent savings institutions between 1985 and 1988, the U.S. government agreed that Sterling could use \$38.0 million of supervisory goodwill associated with the acquisitions to help meet its regulatory capital requirements. In 1989, Congress enacted the Financial Institutions Reform, Recovery and Enforcement Act which provided, among other things, that savings institutions such as Sterling Savings Bank were no longer permitted to include supervisory goodwill in their regulatory capital. Consequently, Sterling Savings Bank was required to discontinue use of its supervisory goodwill in calculating its capital ratios, which resulted in Sterling Savings Bank's failing to comply with its minimum regulatory capital requirements from 1989 through 1991.

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 troubled thrift institutions (the Goodwill Litigation). In the Goodwill Litigation, Sterling seeks damages for, among other things, breach of contract and for deprivation of property without just compensation.

In September 2002, the U.S. Court of Federal Claims granted Sterling Savings Bank's motion for summary judgment as to liability on its contract claim, holding that the United States government owed contractual obligations to Sterling with respect to its acquisition of three failing regional thrifts during the 1980's and had breached its contracts with Sterling. Sterling is waiting for a trial date to be set to determine what amount, if any, the government must pay in damages for its breach. The timing and ultimate outcome of the Goodwill Litigation cannot be predicted with certainty. Because of the effort required to bring the case to conclusion, Sterling likely will continue to incur legal expenses at levels similar to those in 2003 over the next one to two years.

### New Accounting Policies

In December 2003, the Financial Accounting Standards Board (FASB) issued FIN No. 46R, which provides further guidance on the accounting for variable interest entities. Sterling adopted FIN No. 46R as of December 31, 2003 and Sterling has applied the provisions of FIN No. 46R beginning in the first quarter of 2004 by deconsolidating its subsidiary statutory trusts that issue Trust Preferred Securities to investors. The amounts payable to these trusts continue to be treated as other borrowings. The adoption of FIN No. 46R did not have a material effect on Sterling's consolidated financial statements.

In December 2003, the American Institute of Certified Public Accountants issued Statement of Position ( SOP ) No. 03-3, Accounting for Certain Loans or Debt Securities Acquired in a Transfer. 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. Sterling believes the implementation of SOP No. 03-3 will not have 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 is subject to comprehensive examination and regulation by the OTS. Sterling Savings Bank, as a Washington State-chartered savings association, is 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. 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 our 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. We do 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 our 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.



**STERLING FINANCIAL CORPORATION**

**Part II Other Information**

**Item 1 - Legal Proceedings**

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

**Item 2 - Changes in 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 27, 2004. The following was submitted to a vote of the security holders of Sterling at the Meeting:

Election of five Directors to serve for the following terms:

Terms expiring in the year 2007:

|                    |            |            |           |         |
|--------------------|------------|------------|-----------|---------|
| Ned M. Barnes      | Votes for: | 17,671,628 | Withheld: | 395,200 |
| James P. Fugate    | Votes for: | 17,597,516 | Withheld: | 469,312 |
| Robert D. Larrabee | Votes for: | 17,635,607 | Withheld: | 431,221 |

Approximate Broker Non-votes: 0

Term expiring in the year 2006:

|                          |            |            |           |         |
|--------------------------|------------|------------|-----------|---------|
| William Ike L. Eisenhart | Votes for: | 17,555,631 | Withheld: | 511,197 |
|--------------------------|------------|------------|-----------|---------|

Approximate Broker Non-votes: 0

Term expiring in the year 2005:

|                    |            |            |           |         |
|--------------------|------------|------------|-----------|---------|
| Donald N. Bauhofer | Voted for: | 17,943,747 | Withheld: | 123,081 |
|--------------------|------------|------------|-----------|---------|

Approximate Broker Non-votes: 0

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

Rodney W. Barnett  
Thomas H. Boone  
Harold B. Gilkey  
William W. Zuppe

**Item 5 - Other Information**

Not applicable.

**Item 6 - Exhibits and Reports on Form 8-K**

(a)

| <b>Exhibit No.</b> | <b>Exhibit</b>  |
|--------------------|---|
| 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                 | Employment Agreement between Sterling and Harold B. Gilkey, filed as Exhibit 10.7 to Sterling's Annual Report on Form 10-K for the year ended December 31, 1999 and incorporated by reference herein was extended in June 2004 for one year to July 1, 2005.  |
| 31.1               | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. Filed herewith.   |
| 31.2               | Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. Filed herewith.   |
| 32.1               | Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. Filed herewith.  |
| 32.2               | Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. Filed herewith.  |

(b) Reports on Form 8-K. During the quarter ended June 30, 2004, there were two reports filed on Form 8-K.

On April 26, 2004, Sterling filed a report on Form 8-K containing a press release announcing results of operations for the quarter ended March 31, 2004.

On April 27, 2004, Sterling filed a report on Form 8-K containing a press release announcing that the Board of Directors of Sterling declared a 10% stock dividend, payable on May 28, 2004 to shareholders of record at May 10, 2004.

**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, 2004  
Date

By:

/s/ Daniel G. Byrne

**Daniel G. Byrne**

Executive Vice President, Assistant Secretary,  
and  
Principal Financial Officer

August 9, 2004  
Date

By:

/s/ William R. Basom

**William R. Basom**

Vice President, Treasurer, and Principal  
Accounting Officer