STERLING FINANCIAL CORP /WA/
Form 424B3
March 09, 2011
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Filed Pursuant to Rule 424(B)(3)

Registration Statement No. 333-169579

PROSPECTUS SUPPLEMENT

(To Prospectus dated November 16, 2010)

STERLING FINANCIAL CORPORATION

63,764,208 Shares of Common Stock

Warrants to Purchase 2,722,541 Shares of Common Stock

RECENT DEVELOPMENTS

We have attached to this prospectus supplement, and incorporated by reference into it, our Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 8, 2011.

March 9, 2011

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the year ended DECEMBER 31, 2010

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 001-34696

STERLING FINANCIAL CORPORATION

(Exact name of registrant as specified in its charter)

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

111 North Wall Street, Spokane, Washington 99201

(Address of principal executive offices) (Zip code)

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

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

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

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

(Title of class) Common Stock

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

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

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

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

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

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

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

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

As of June 30, 2010, the aggregate market value of the common equity held by non-affiliates of the registrant, computed by reference to the average of the bid and asked prices on such date as reported by the NASDAQ Capital Market, was $28 million.

The number of shares outstanding of the registrant s common stock as of January 31, 2011 was 61,929,501.

DOCUMENTS INCORPORATED BY REFERENCE

Specific portions of the registrant s Proxy Statement for its 2011 annual meeting of shareholders are incorporated by reference into Part III hereof.

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STERLING FINANCIAL CORPORATION

DECEMBER 31, 2010 ANNUAL REPORT ON FORM 10-K

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PART I

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

Item 1. Business

General

Sterling Financial Corporation is a bank holding company, organized under the laws of Washington State in 1992, the principal operating subsidiary of which is Sterling Savings Bank. References to Sterling, the Company, we, our, or us in this report refer to Sterling Financial Corporation, a Washington corporation, and its consolidated subsidiaries on a combined basis, unless otherwise specified or the context otherwise requires. References to Sterling Savings Bank refer to our subsidiary Sterling Savings Bank, a Washington state-chartered commercial bank. References to our subsidiary bank or our banking subsidiary refer to Sterling Savings Bank. Sterling Savings Bank, headquartered in Spokane, Washington, commenced operations in 1983 as a Washington State-chartered, federally insured, stock savings and loan association, and in 2005 converted to a commercial bank. Sterling Savings Bank offers commercial banking products and services, mortgage lending, construction financing and investment products to individuals, small business, commercial organizations and corporations.

Sterling s dedication to personalized service and relationship banking has enabled it to attract both retail deposits and lending relationships in the western United States. With $9.49 billion in total assets as of December 31, 2010, Sterling originates loans and attracts Federal Deposit Insurance Corporation (FDIC) insured and uninsured deposits from the general public throughout its footprint through Sterling Savings Bank. On August 2, 2010, Golf Savings Bank, which was a wholly owned subsidiary of Sterling, was merged into Sterling Savings Bank, with the residential units of both banks combined within the home loan division (Home Loan Division) of Sterling Savings Bank. The Home Loan Division originates residential loans, both for sale into the secondary market and for the loan portfolio. Sterling also markets fixed income and equity products, mutual funds, annuities and other financial products through wealth management representatives located across Sterling s network of financial service centers.

Recent Developments

Sterling recorded a net loss of $224.3 million for the year ended December 31, 2010 compared with a net loss of $838.1 million for the year ended December 31, 2009. The results for 2010 included a provision for credit losses of $250.2 million. In addition, Sterling recorded a $90.0 million increase in the allowance against the deferred tax asset, which resulted in Sterling not recognizing an income tax benefit during 2010. By comparison, 2009 results included a provision for credit losses of $681.4 million and an initial allowance against the deferred tax asset of $269.0 million. The 2009 results also included a non-cash goodwill impairment charge of $227.6 million. Earnings per common share for 2010 included two separate non-cash items related to the Recapitalization Transactions, as defined below.

On August 26, 2010, Sterling completed several transactions as part of its recapitalization and recovery plan, receiving $730.0 million in aggregate proceeds (collectively, the Recapitalization Transactions or the Recapitalization). The Recapitalization consisted of three principal transactions.

- an investment of approximately $170.9 million by each of (a) Thomas H. Lee Equity Fund VI, L.P., Thomas H. Lee Parallel Fund VI, L.P., Thomas H. Lee Parallel (DT) Fund VI, L.P. and THL Sterling Equity Investors, L.P. (collectively, THL or an Anchor Investor) and (b) Warburg Pincus Private Equity X, L.P. (Warburg Pincus or an Anchor Investor), pursuant to which each received 1,035,848 shares of common stock, 1,709,150 shares of Series B preferred stock, and a seven-year warrant to purchase 1,312,500 shares of common stock at an exercise price of $14.52 per share (the Anchor Investments);

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the exchange of 303,000 shares of preferred stock held by the U.S. Department of the Treasury (Treasury) at a discounted exchange value into 5,738,636 shares of common stock at a conversion price of $13.20 per share, and amendment of the terms of the warrant held by Treasury (the Treasury Warrant) to provide for a revised exercise price of $13.20 per share for a ten-year term for 97,540.56 shares of Sterling common stock (the Treasury Exchange), effected pursuant to an exchange agreement between Sterling and Treasury (the Exchange Agreement); and

investments by accredited investors (the Private Placement Investors) of an aggregate of $388.2 million in exchange for an aggregate of 2,352,545 shares of common stock and 3,881,700 shares of Series D preferred stock.

The Treasury Exchange resulted in a gain of $84.3 million because the book value of the preferred stock plus accrued dividends was greater than the $230.9 million fair value of the common stock issued to Treasury and the fair value of the new warrant. This is accounted for as a non-cash increase in income available to common shareholders, but had no effect on Sterling s overall equity or its regulatory capital position.

The issuance price of $13.20 per share for the Series B and D preferred stock on an as-converted basis represented a $26.40 per share discount from the common stock s market price of $39.60 per share. For accounting purposes, this discount is considered a beneficial conversion feature. Accordingly, Sterling recorded this discount, valued at $604.6 million in aggregate, as a reduction to preferred stock and as an increase to common stock.

On September 27, 2010, Sterling announced that its banking regulators had terminated the cease and desist order put in place in October 2009 with Sterling Savings Bank, reflecting a strengthened balance sheet and capital position. Since termination of the cease and desist order, Sterling Savings Bank has been deemed well-capitalized by its regulators. Although the cease and desist order is no longer applicable, Sterling Savings Bank will continue to be subject to enhanced supervisory review by the FDIC and the Washington Department of Financial Institutions (WDFI) under a memorandum of understanding (the SSB MOU), pursuant to which Sterling Savings Bank must maintain Tier 1 capital in an amount that ensures that its leverage ratio is at least 8 percent. Sterling Savings Bank will also be required to meet certain asset quality targets and comply with other requirements. As of the date of this filing, Sterling continues to be subject to a regulatory agreement (the Reserve Bank Agreement) with the Federal Reserve Bank of San Francisco (the Reserve Bank). The Reserve Bank Agreement is intended to enhance Sterling s ability to act as a source of strength to Sterling Savings Bank. See Management s Discussion and Analysis (MD&A) Regulatory Agreements.

On October 21, 2010, Sterling held a Special Meeting at which shareholders approved: (1) the increase in the authorized number of shares of common stock from 11,363,636 to 151,515,151; (2) the conversion of outstanding Series B and D preferred stock into, and the exercisability of the warrants issued to THL and Warburg Pincus for shares of common stock; and (3) an amendment to Sterling s Restated Articles of Incorporation to authorize a reverse stock split, which occurred on November 19, 2010, at a rate, as determined by the board of directors, of 1-for-66. All per share amounts that are presented in this Form 10-K have been restated to reflect this reverse split.

On October 22, 2010 the series B and D preferred stock were converted into 50,878,788 shares of common stock. Upon conversion the $604.6 million discount was amortized and recognized as a non-cash dividend paid to the preferred shareholders, and had no effect on Sterling s overall equity or its regulatory capital position.

Recent additions to Sterling s board of directors and executive management team bring a broad level of financial services and corporate executive management experience, as well as regulatory expertise. Leslie S. Biller, the former vice chairman and chief operating officer of Wells Fargo & Company, now serves as non-executive chairman of Sterling s board. Additional board appointments include David A. Coulter, managing director of Warburg Pincus and former chairman and chief executive officer of BankAmerica Corp.; Scott L. Jaeckel, managing director of THL and director for several public and private companies; Howard P. Behar, past president, North America, of Starbucks

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Coffee Company; Robert C. Donegan, president of Seattle based Ivar s Inc.; C. Webb Edwards, formerly president of Wells Fargo Services Company, the technology, call center and operations subsidiary of Wells Fargo & Company; and Robert H. Hartheimer, a former FDIC division director, investment banker and regulatory consultant. As of the date of this report, the appointments of Mr. Behar and Mr. Edwards remain subject to regulatory approval. Recent management additions include two industry veterans: David S. DePillo, who joined as chief credit officer during 2010; and subsequent to year end, Patrick J. Rusnak, who joined as chief financial officer.

Business Strategy

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

- *Knowledgeable bankers* Employee development, training and compensation initiatives designed to enable our talented team of bankers to capably serve our customers across our footprint.

- *Fair pricing* Offer a meaningful value proposition for our customers, while providing competitive funding and returns.

- *Convenience and ease of use* We operate 178 retail banking locations and 33 mortgage loan origination offices; we provide customer-oriented hours, full-service net banking and on-line bill pay. Our goal is to meet our customers where they want to be met.

- *Competitive products and services* We offer a full range of consumer, small business, commercial, corporate, wealth management and mortgage banking products and services across our five-state footprint. Our treasury management products include an advanced and easy to use Remote Deposit Capture system that rivals those of the largest banks operating in our area.

Our back to basics banking model is built around the development of core customer relationships. Our main focus during 2010 continued to be on credit management, operating efficiency and the repositioning of our balance sheet. We realigned our organization by adding experienced and talented individuals to our operations and by incorporating the following strategies:

- *Strengthening Asset Quality Oversight and Resolution.* Sterling s credit administration group focuses on identifying and resolving classified assets that are currently or expected to become problem assets, including construction and commercial real estate related assets. Sterling continues to execute its strategic goal of achieving targeted levels of loan portfolio diversification while addressing issues related to problem assets. In addition, Sterling s asset recovery team proactively markets other real estate owned (OREO). Classified assets declined 32% during 2010.

- *Emphasizing Growth in Multifamily, Commercial Business and Consumer Lending While Reducing Exposure to Construction and Commercial Real Estate Loans.* Sterling s 65% reduction in the concentration of construction loan balances during 2010 influenced the quarterly reductions in the provision for loan losses. Building core business and consumer banking relationships within the commercial, consumer and multifamily banking teams will further rebalance the loan portfolio, improving the overall mix of earning assets, reducing credit risks and helping Sterling achieve increased risk adjusted returns.

- *Originating Lower-Cost Core Deposits with Relationship Banking Initiatives.* Sterling has implemented a number of relationship-focused deposit initiatives to grow core deposits, while improving the overall mix of deposits. The change in deposit mix and market conditions have contributed to Sterling s cost of funds decreasing from 2.28% for 2009 to 1.69% for 2010.

Expanding and Diversifying Fee Income. Sterling continues to develop and enhance its offering of financial products and services to grow fee and service charge income. Our emphasis on responsiveness, simplicity and customer support continues to positively influence residential loan originations, while an experienced secondary marketing team secures profitable fee income

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from mortgage banking operations. Bringing together full relationship banking, cash management products and services, and fair pricing with Sterling s Hometown Helpful value proposition provides growth opportunities for transaction, service and account fees. Over the long-run, delivering consistent customer value and satisfaction provides the firm foundation to grow fee income.

Improving Operating Efficiency Through Improved Expense Management. In an effort to maximize core earnings and offset credit-related expenses, Sterling has implemented several initiatives to improve efficiency, including the August 2010 merger of Golf Savings Bank into Sterling Savings Bank.

Maintaining Well-Capitalized Levels. Following the Recapitalization Transactions, Sterling and Sterling Savings Bank exceed the requirements to be deemed well-capitalized and also exceed the levels required by the SSB MOU. Sterling has developed strategies to maintain its capital at appropriate levels to meet regulatory requirements. Sterling s tier 1 leverage ratio was 10.1% at December 31, 2010, compared to 3.5% at December 31, 2009.

Back to basics banking is a focus on the customer; it reflects a Sterling belief that every customer deserves a banking relationship built on trust and a superior experience with every interaction. We lowered our balance sheet risk profile by reducing concentrations of construction loans and wholesale borrowings, and strengthened capital levels through the Recapitalization Transactions. Sterling s improvements in core funding and reductions in the cost of such funding show ongoing progress in growing core business and consumer customer relationships.

Profitability Drivers

Achieving profitability depends upon executing the following strategies:

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

Sterling believes these strategies, combined with our initiatives to manage risk, will contribute to high quality, consistent earnings, and build shareholder value. The effect of these strategies on Sterling s financial results is discussed further in the MD&A.

Segments

For purposes of measuring and reporting financial results during 2010, 2009 and 2008, Sterling was divided into five business segments:

The Community Banking segment provides traditional banking and wealth management services through the retail, private and commercial banking groups of Sterling Savings Bank.

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

The Residential Mortgage Banking segment originates and sells residential loans on a servicing-retained and servicing-released basis

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through loan production offices of the Home Loan Division. The Home Loan Division s operations were previously performed primarily by Sterling s subsidiary Golf Savings Bank, which on August 2, 2010 was merged into Sterling Savings Bank.

The Commercial Mortgage Banking segment originates, sells and services commercial real estate loans and participation interests in commercial real estate loans through offices in the western region of the United States.

The Other and Eliminations segment represents the parent company expenses and intercompany eliminations of revenue and expenses. The results of operations are reported by segment in the accompanying notes to the consolidated financial statements.

Lending Activities

Descriptions of Sterling s relationship focused lending products are as follows:

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

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

Sterling has established underwriting standards to review new and renewing commercial loans. These criteria include analysis of sources of repayment, financial strength and other credit enhancements such as guarantees. Typically, the primary source of repayment is recurring cash flow of the borrower or cash flow from the business or project being financed. Depending on the type of loan, underwriting standards include minimum financial requirements, maximum loan-to-collateral value ratios, minimum cash flow coverage of debt service, debt-to-income ratios, and minimum liquidity requirements. Exceptions to the minimum underwriting standards may be made depending upon the type of loan and financial strength of the borrower. Exceptions are reported to the appropriate level of authority up to and including the board of directors. Common forms of collateral pledged to secure commercial banking loans include real estate, accounts receivable, inventory, equipment, agricultural crops or livestock and marketable securities. Most loans have maximum terms of one to ten years and loan-to-value ratios in the range of 50% to 80%, based on an analysis of the collateral pledged.

Commercial banking loans generally are backed by collateral that may be difficult to obtain or to liquidate following a default. However, these loans typically offer higher yields than residential loans and include variable interest rates. Establishing full-service deposit and cash management banking relationships with Sterling provides business customers with more ready access to lending facilities and generally improves the overall creditworthiness and profitability of the total relationship.

Multifamily Residential and Commercial Real Estate Lending. Sterling offers multifamily residential and commercial real estate loans as both construction and permanent loans collateralized by real property. Construction loans on such properties typically have terms of 12 to 24 months and have

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variable interest rates. Permanent fixed- and adjustable-rate loans on existing properties typically have maturities of three to ten years. Multifamily residential and commercial real estate loans generally involve a higher degree of risk than one- to four-family residential real estate loans, because they typically involve large loan balances to single borrowers or groups of related borrowers. The payment experience on such loans typically depends on successfully operating the real estate project and is subject to certain risks not present in one- to four-family residential mortgage lending. These risks include excessive vacancy rates or inadequate operating cash flows. Construction lending is subject to risks such as construction delays, cost overruns, insufficient values and an inability to obtain permanent financing in a timely manner.

One- to Four-Family Residential Lending. Sterling originates residential mortgages underwritten to correspond to agency and investor guidelines. Loans are originated through Sterling s network of retail mortgage offices and consumer direct lending channels. Products include: a) fixed-rate residential mortgages; b) adjustable-rate residential mortgages (ARMs), which have interest rates that adjust annually with a fixed period of three, five or seven years and are indexed to a variety of market indices; c) and interest only residential mortgages underwritten to amortizing payment standards. Sterling focuses its residential lending efforts on originating traditional amortizing loans for owner occupied homes, second homes and investment properties.

Residential loans Sterling originates that meet agency guidelines are primarily sold into the secondary mortgage market. Within the secondary mortgage market, Sterling sells its conventional residential loans on a servicing-retained basis to the Federal Home Loan Mortgage Corporation (Freddie Mac) and to the Federal National Mortgage Association (Fannie Mae). Loans sold on a servicing-released basis to investors include government guaranteed loans, program specific conventional loans, and fixed rate jumbo loans. Sterling retains a portion of conventional ARMs and jumbo ARMs as held for investment loans. Loans sold into the secondary market are sold with limited recourse to Sterling, meaning that Sterling may be obligated to repurchase any loans that are not underwritten in accordance with agency guidelines or loans with identified post-closing borrower misrepresentations. Sterling maintains a credit loss reserve to cover the costs associated with these potential repurchases. See Note 17 of Notes to Consolidated Financial Statements.

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

Residential Construction Lending. Sterling originates residential construction loans, but the number of new, viable, residential construction projects that meet Sterling s underwriting standards has been limited during the current economic cycle. Construction financing is generally considered to involve a higher degree of risk than long-term financing on improved, occupied real estate. Sterling s risk of loss on construction loans depends largely upon the value of the underlying property, and the estimated cost (including interest) of the project. If the estimate of construction costs proves to be inaccurate, Sterling might have to advance funds beyond the amount originally committed to permit completion of the development and to protect its security position. Sterling s underwriting, monitoring and disbursement practices with respect to construction financing are intended to ensure that sufficient funds are available to complete construction projects. Sterling endeavors to limit its risk through its underwriting procedures by using only approved, qualified appraisers and by dealing only with qualified builders/borrowers.

Consumer Lending. Consumer loans and lines of credit are originated directly through Sterling s retail branches and Private Banking teams, and indirectly through Sterling s Dealer Banking Department. Sterling finances purchases of consumer goods including automobiles, boats and recreational vehicles, and lines of credit for personal

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use. Generally, consumer loans are originated for terms ranging from six months to ten years. Interest rates may be either fixed or adjustable based on a contractual formula tied to established external indices. Sterling also makes loans secured by borrowers savings accounts and equity loans collateralized by residential real estate. Equity loans may have maturities of up to 20 years.

Sterling s Private Banking teams provide a full line of financial and credit services to higher-net-worth and higher-income borrowers, including personalized services for a wide variety of consumer loans. The Private Banking teams also serve the needs of the owners and key employees of the Commercial Banking customers.

Secondary Market Activities. Sterling has developed correspondent relationships with a number of mortgage companies and financial institutions to facilitate the sale of mortgage loans on a servicing-retained or released basis. Sterling generally receives a fee of approximately 100 to 200 basis points of the principal balance of mortgage loans for releasing the servicing. For sales of loans on a servicing-retained basis, Sterling records a servicing asset of approximately 100 to 150 basis points of the principal balance. At December 31, 2010 and 2009, Sterling had recorded $20.6 million and $12.1 million in servicing rights, respectively.

Sterling purchases mortgage loans in the secondary market. Agents who present loans to Sterling for purchase are required to provide a processed loan package prior to commitment. Sterling then underwrites the loan in accordance with its established lending standards. During 2010, Sterling purchased $82.7 million of multifamily loans in the secondary market, while in 2009, no loan purchases were transacted.

During the years ended December 31, 2009 and 2008, Sterling sold $20.9 million and $15.8 million, respectively, in loans under participation agreements, resulting in net gains of $1.6 million and $24,000, respectively. During 2010, Sterling did not enter into any of these transactions.

Derivatives and Hedging. As part of its mortgage banking activities, commitments to prospective borrowers on residential mortgage loan applications may have the interest rates fixed for a period of 10 to 60 days (interest rate lock commitments). To offset the exposure to interest rate risk, the pricing for the sale of these loans is fixed with various qualified investors under both non-binding (best-efforts) and binding (mandatory) delivery programs. For mandatory delivery programs, Sterling hedges interest rate risk by entering into offsetting forward sale agreements on mortgage-backed securities (MBS) with third parties. Risks inherent in mandatory delivery programs include the risk that if Sterling does not close the loans subject to interest rate lock commitments, it is nevertheless obligated to deliver MBS to the counterparty under the forward sale agreement. Sterling could incur significant costs in acquiring replacement loans or MBS and such costs could have a material adverse effect on mortgage banking operations in future periods.

Interest rate lock commitments and loan delivery commitments are off balance sheet commitments that are considered to be derivatives. As of December 31, 2010, Sterling had $118.6 million of interest rate lock commitments, $207.0 million of residential mortgage loans held for sale that were not committed to investors and offsetting forward sale agreements on MBS valued at $285.3 million. In addition, Sterling had mandatory delivery commitments to sell mortgage loans to investors valued at $800,000 as of December 31, 2010. As of December 31, 2009, Sterling had $110.0 million of interest rate lock commitments, $119.7 million of residential mortgage loans held for sale that were not committed to investors and offsetting forward sale agreements on MBS valued at $234.0 million. In addition, Sterling had mandatory delivery commitments to sell mortgage loans to investors valued at $29.5 million as of December 31, 2009. As of December 31, 2010 and 2009, Sterling had entered into best efforts forward commitments to sell $18.5 million and $51.6 million of mortgage loans, respectively.

From time to time, Sterling may enter into interest rate swap transactions with loan customers. The interest rate risk on these swap transactions is managed by entering into offsetting interest rate swap agreements with various counterparties (broker-dealers or dealers). The counterparty swap agreements include certain representations, warranties and covenants, which include terms that

allow for an early termination in the event of default. Failure to maintain a well-capitalized position is one event that may be considered a default, and counterparties to the swap agreements could require an early termination settlement or an increase in the collateral to secure derivative instruments that are in net liability positions to Sterling. During 2010, no counterparties declared an early termination event. As a result of the Recapitalization Transactions, management believes that Sterling is not likely to experience an early termination event in connection with its capital levels. Both customer and dealer related interest rate derivatives are carried at fair value by Sterling.

Loan Servicing. Sterling services its own loans, as well as loans owned by others. Loan servicing includes collecting and remitting loan payments, accounting for principal and interest, holding escrow funds for the payment of real estate taxes and insurance premiums, contacting delinquent borrowers and supervising foreclosures in the event of unremedied defaults. For loans serviced for others, Sterling generally receives a fee based on the unpaid principal balance of each loan to compensate for the costs of performing the servicing function.

For residential mortgage loans serviced for other investors, Sterling receives a fee, generally ranging from 5 to 25 basis points of the unpaid principal balance. At December 31, 2010 and 2009, Sterling serviced for itself and for other investors, residential mortgage loans totaling $2.66 billion and $1.88 billion, respectively. Of such mortgage loans, $1.94 billion in 2010 and $1.09 billion in 2009 were primarily serviced for Freddie Mac and Fannie Mae.

Sterling receives a fee for servicing commercial and multifamily real estate loans for other investors. This fee generally ranges from 5 to 25 basis points of the unpaid principal balance. At December 31, 2010 and 2009, Sterling serviced for itself and other investors, commercial and multifamily real estate loans totaling $3.28 billion and $3.45 billion, respectively.

Classified and Nonperforming Assets. To measure the quality of loans and OREO, Sterling has established guidelines for classifying and determining provisions for anticipated losses. Sterling s system employs the risk rating categories of substandard, doubtful and loss for its classified assets. Substandard assets have deficiencies, which give rise to the distinct possibility that Sterling will sustain some loss if the deficiencies are not corrected. Doubtful assets have the same weaknesses as substandard assets, and on the basis of currently existing facts, are also deemed to have a high probability of loss. An asset classified as loss is considered uncollectible and of such little value that it should not be included as an asset of Sterling. Total classified assets were $1.12 billion at December 31, 2010, down from $1.65 billion at December 31, 2009. As a percentage of total assets, classified assets were 11.8% and 15.2% as of December 31, 2010 and 2009, respectively. See MD&A Financial Position *Loans Receivable.*

One of the roles of the credit administration group is to focus on identifying and resolving potential problem credits before they become classified. When an asset becomes classified, management of the relationship is assumed by Sterling s special assets department. Sterling actively engages the borrower and guarantor to remedy the situation by requesting updated financial information from the borrower(s) and guarantor(s) to determine a course of action. In addition, updated collateral values are obtained in order for Sterling s management to perform evaluations for regulatory and decision making purposes and updated title information is obtained to determine the status of encumbrances on the collateral. When possible, Sterling will require the borrower to provide additional collateral or capital. In conjunction with the receipt of additional collateral, Sterling will sometimes modify the terms of the loan. Often the new modified terms of the loan are consistent with terms that Sterling would offer a new borrower. If the modification of terms is considered concessionary, Sterling classifies the loan as a Troubled Debt Restructure and reports it as a nonperforming loan.

Sterling also may consider allowing a borrower to sell the underlying collateral for less than the outstanding balance on the loan if the current collateral evaluation supports the offer price. These transactions are known as short sales. In such situations, Sterling typically requires the borrower to sign a new note for the resulting deficiency or bring cash to closing.

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If Sterling and a borrower are unable to achieve an acceptable resolution, Sterling may take a deed in lieu of foreclosure or initiate foreclosure on the underlying collateral. Under such circumstances, Sterling also simultaneously evaluates legal action for recovery against the borrowers and guarantors. After obtaining the collateral, Sterling actively works to sell the collateral.

Allowance for Credit Losses. Sterling regularly reviews its classified assets for impairment. If a loan is determined to be impaired, Sterling performs a valuation analysis on the loan. Valuation analysis compares the estimated fair value (market value less selling costs, foreclosure costs and projected holding costs), and the book balance (loan principal and accrued interest or carrying value of OREO). For loans that are considered collateral dependent, the difference between the fair value and the book value is charged off as a confirmed loss. Sterling may record a specific reserve on collateral dependent impaired loans to recognize market declines since the last appraisal. For certain non-collateral dependent loans, Sterling establishes a specific reserve for the difference between fair value and book value of these loans, as the loss is not defined as a confirmed loss because it is not based solely on collateral values. Allowances are established and periodically adjusted, if necessary, based on the review of information obtained through on-site inspections, market analysis, appraisals and purchase offers.

Sterling maintains an allowance for credit losses at a level deemed appropriate by management to adequately provide for probable losses related to specifically identified loans and probable losses in the remaining portfolio, as well as unfunded commitments. The allowance is based upon historical loss experience, loan migration analysis, delinquency trends, portfolio size, concentrations of risk, prevailing and anticipated economic conditions, industry experience, estimated collateral values, management s assessment of credit risk inherent in the portfolio, specific problem loans and other relevant factors. The portfolio is grouped into standard industry categories for homogeneous loans based on characteristics such as loan type, borrower and collateral. Information regarding annual and quarterly loan migration to loss is used to determine the probability of default. Loss experience from the most recent 12 months is used to estimate the amount that would be lost if a default were to occur, which is termed the loss given default. The probability of default is multiplied by the loss given default to calculate the expected losses for each loan category.

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

Investments and Mortgage-Backed Securities

At December 31, 2010 and 2009, investments and MBS classified as available for sale were $2.83 billion and $2.16 billion, respectively. The carrying value of these investments and MBS at December 31, 2010 includes net unrealized losses of $6.5 million, compared with net unrealized gains of $25.8 million as of December 31, 2009. Fluctuations in prevailing interest rates continue to cause volatility in this component of accumulated comprehensive income and may continue to do so in future periods. Investments and MBS that management has the positive intent and ability to hold to maturity are classified as held to maturity and carried at amortized cost. At December 31, 2010 and 2009, investments classified as held to maturity were $13.5 million and $17.6 million, respectively. See MD&A Critical Accounting Policies *Investments and MBS.*

Sterling invests primarily in MBS issued by Freddie Mac, Fannie Mae and the Government National Mortgage Association (Ginnie Mae), and has limited investments in other non-agency obligations. Such investments provide Sterling with a relatively liquid source of interest income and collateral, which can be used to secure borrowings.

Sources of Funds

Sterling s primary sources of funds are: retail, public and brokered deposits; the collection of principal and interest primarily from loans, as well as from mortgage backed securities; the sale of loans into the secondary market in connection with Sterling s mortgage banking activities; borrowings from the

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Federal Home Loan Bank (FHLB) and the Federal Reserve; and borrowings from commercial banks (including reverse repurchase agreements). The availability and volume of these funds are influenced significantly by prevailing interest rates and other economic conditions, as well as regulatory statutes. Borrowings may be used on a short-term basis to compensate for reductions in other sources of funds (such as deposit inflows at less than projected levels). Borrowings may also be used on a longer-term basis to support expanded lending activities and to match repricing intervals of assets. See Lending Activities and Investments and Mortgage-Backed Securities.

Deposit Activities. Sterling offers a wide variety of deposit products and related services to businesses, individuals, and public sector entities throughout its primary market areas. Deposit accounts include transaction (checking) accounts, savings accounts, money market demand accounts (MMDA), and certificates of deposit (CDs). These deposit products and services are marketed by its 178 depository banking offices and each of its private and commercial banking offices. Sterling offers both interest- and noninterest bearing checking accounts, MMDA, CDs and savings accounts that earn interest at rates established by management and are based on a competitive market analysis. The method of compounding varies from simple interest credited at maturity to daily compounding, depending on the type of account.

With the exception of certain promotional CDs and variable-rate products, most CDs carry a fixed rate of interest for a defined term from the opening date of the account. Penalties are imposed if principal is withdrawn from most CDs prior to maturity.

Sterling competes with other financial institutions and financial intermediaries in attracting deposits. There is strong competition for transaction, money market and time deposit balances from commercial banks, credit unions and nonbank corporations, such as securities brokerage companies, mutual funds and other diversified companies, some of which have nationwide networks of offices. Many of Sterling s marketing efforts have been directed toward attracting additional deposit customer relationships and balances. Sterling provides electronic banking products, including debit card, online banking, bill pay, merchant services and treasury management services, which include remote deposit capture. All of these products and services are intended to enhance customer relationships and attract and increase retail deposit balances.

Sterling has 169 automated teller machines (ATM). Customers also can access ATMs operated by other financial institutions. Sterling is a member of the Plus System ATM network that allows participating customers to deposit or withdraw funds from transaction accounts, MMDA and savings accounts at numerous locations in the United States and internationally.

Sterling supplements its retail deposit gathering by soliciting funds from public entities and through the acquisition of brokered deposits. Public funds are generally obtained by competitive bidding among qualifying financial institutions, and usually require Sterling to provide collateral in the form of qualifying securities for any non FDIC insured portion of the deposit. Brokered deposits were 4% and 14% of deposits at December 31, 2010 and 2009, respectively. Public funds were 12% and 11% of deposits at December 31, 2010 and 2009, respectively.

Borrowings. Although deposit accounts are Sterling s primary source of funds, Sterling also uses other borrowings to supplement its deposit gathering efforts. These borrowings include advances from the FHLB, reverse repurchase agreements, primary credits and term auction facilities from the Federal Reserve, as well as federal funds purchased. See MD&A Liquidity and Capital Resources.

The FHLB of Seattle is part of a system that consists of 12 regional Federal Home Loan Banks that provide secured credit to financial institutions. As a condition of membership in the FHLB of Seattle, Sterling Savings Bank is required to own stock of the FHLB of Seattle in an amount determined by a formula based upon the larger of its total qualifying mortgages and MBS, or total advances from the FHLB of Seattle. At December 31, 2010, Sterling Savings Bank held more than the minimum FHLB of Seattle stock ownership requirement.

Sterling also borrows funds under reverse repurchase agreements with major broker/dealers and financial entities pursuant to which it sells investments (generally, U.S. agency obligations and MBS) under

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an agreement to buy them back at a specified price at a later date. These agreements to repurchase are deemed to be borrowings collateralized by the investments and MBS sold. Sterling uses these borrowings to supplement deposit gathering for funding the origination of loans. Sterling had $1.03 billion in reverse repurchase agreements outstanding at both December 31, 2010 and 2009. The use of reverse repurchase agreements and other secured borrowings may expose Sterling to certain risks, including the possibility that additional collateral may have to be provided if the market value of the pledged collateral declines.

Subsidiaries

Sterling s principal operating subsidiary is Sterling Savings Bank. See exhibit 21.1 for a complete list of subsidiaries for Sterling and Sterling Savings Bank.

Competition

Sterling faces strong competition, both in attracting deposits and in originating, purchasing and selling loans, from commercial banks, savings and loan associations, mutual savings banks, credit unions and other institutions, many of which have greater resources than Sterling. Sterling also faces strong competition in marketing financial products such as annuities, mutual funds and other financial products and in pursuing acquisition opportunities. Some or all of these competitive businesses operate in Sterling s market areas. As of June 30, 2010, Sterling Savings Bank s deposit market share was as follows:

State	Branches	Rank	Market Share
Washington	72	7	3.20%
Oregon	67	7	3.58%
California	13	46	0.14%
Idaho	18	11	2.57%
Montana	8	14	1.21%

Personnel

As of December 31, 2010, Sterling had 2,498 full-time equivalent employees. Employees are not represented by a collective bargaining unit. Sterling believes it has good relations with its employees.

Regulation

The following is not intended to be a complete discussion but is intended to be a summary of some of the more significant provisions of laws applicable to Sterling and its subsidiaries. This regulatory framework is intended to protect depositors, federal deposit insurance funds and the banking system as a whole, and not to protect security holders. To the extent that the information describes statutory and regulatory provisions, it is qualified in its entirety by reference to those provisions. Further, such statutes, regulations and policies are continually under review by Congress and state legislatures, and federal and state regulatory agencies. A change in statutes, regulations or regulatory policies applicable to Sterling, including changes in interpretation or implementation thereof, could have a material effect on Sterling s business.

General. As a bank holding company, Sterling is subject to regulation, examination and supervision by the Board of Governors of the Federal Reserve under the Bank Holding Company Act of 1956, as amended (the BHCA), and by the WDFI. Our subsidiary Sterling Savings Bank is a Washington state-chartered commercial bank, and its deposits are insured by the FDIC. It is subject to regulation, examination and supervision by the FDIC and the WDFI. Numerous federal and state laws, as well as regulations promulgated by the Federal Reserve, the FDIC and state banking regulators, govern almost all aspects of the operation of our bank subsidiary, and Sterling s non-bank subsidiaries are also subject to regulation by applicable federal and state agencies for the states in which they conduct business.

Bank Holding Company Regulation. The BHCA limits a bank holding company s business to owning or controlling banks and engaging in other banking-related activities. Bank holding companies must obtain the Federal Reserve s approval before they: (1) acquire direct or indirect ownership or control of any voting shares of any bank that results in total ownership or control, directly or indirectly, of more than 5% of the voting shares of such bank; (2) merge or consolidate with another bank holding company; or (3) acquire substantially all of the assets of any additional banks. Subject to certain state laws, such as age and contingency restrictions, a bank holding company that is adequately capitalized and adequately managed may acquire the

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assets of both in-state banks and out-of-state banks. With certain exceptions, the BHCA prohibits bank holding companies from acquiring direct or indirect ownership or control of voting shares in any company that is not a bank or a bank holding company unless the Federal Reserve determines that the activities of such company are incidental or closely related to the business of banking. If a bank holding company is well-capitalized and meets certain criteria specified by the Federal Reserve, it may engage *de novo* in certain permissible non-banking activities without prior Federal Reserve approval.

A number of provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act), a few of which are described here, will affect the regulation and operations of bank holding companies. Pursuant to the statute, the FDIC is given back-up supervisory authority over bank holding companies engaging in conduct that poses a foreseeable and material risk to the Deposit Insurance Fund, and the Federal Reserve gains heightened authority to examine, prescribe regulations and take action with respect to all of a bank holding company s subsidiaries. A newly created agency, the Office of Financial Research, will have authority to collect data from all financial institutions for the purpose of studying threats to U.S. financial stability. Bank holding companies with $10 billion or more in assets will also be required to conduct and publish the results of annual stress tests. See Risk Factors Recent changes have created regulatory uncertainty.

Holding companies of banks chartered under Washington law are subject to applicable provisions of Washington s banking laws and to the examination, supervision and enforcement powers of the WDFI. Among other powers, the WDFI has the authority to issue and enforce cease and desist orders on such holding companies and to bring actions to remove their directors, officers and employees.

Change in Control. Subject to certain exceptions, the BHCA and the Change in Bank Control Act, together with regulations promulgated thereunder, require Federal Reserve approval prior to any person or company acquiring control of a bank or bank holding company. Control is conclusively presumed to exist if an individual or company acquires 25% or more of any class of voting securities. Control is rebuttably presumed to exist if a person acquires 10% or more, but less than 25%, of any class of an institution s voting securities and either that institution has registered securities under Section 12 of the Exchange Act or no other person owns a greater percentage of that class of voting securities immediately after the transaction. In certain cases, a company may also be presumed to have control under the Bank Holding Company Act if it acquires 5% or more of any class of voting securities.

On September 22, 2008, the Federal Reserve issued a policy statement on minority equity investments in banks and bank holding companies that permits investors without triggering the various regulatory requirements associated with control to (1) acquire up to 33% of the total equity of a target bank or bank holding company, subject to certain conditions including (but not limited to) the condition that the investing firm does not acquire 15% or more of any class of voting securities, and (2) designate at least one director to serve on the board of directors.

Pursuant to the Dodd-Frank Act, a bank holding company may acquire control of an out-of-state bank only if the bank holding company is well-capitalized and well-managed, and interstate merger transactions are prohibited unless the resulting bank would be well-capitalized and well-managed following the transaction.

Washington state law requires that the WDFI be given notice at least 30 days in advance of any proposed change of control of a Washington state-chartered bank. Washington law defines control of an entity to mean directly or indirectly, alone or in concert with others, to own, control or hold the power to vote 25% or more of the outstanding stock or voting power of the entity.

Capital Requirements. The Federal Reserve has adopted guidelines pursuant to which it assesses the adequacy of capital in examining and supervising a bank holding company such as Sterling, and in analyzing applications to it under the Bank Holding Company Act. The FDIC has adopted similar guidelines to assess the adequacy of capital in state-chartered non-member banks such as Sterling Savings Bank. These guidelines include quantitative

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measures that assign risk weightings to assets and off-balance sheet items and that define and set minimum regulatory capital requirements. The definitions of capital and the tests for measuring the adequacy of capital required by the Federal Reserve for bank holding companies and by the FDIC for state-chartered non-member banks are similar, but not identical.

In general, all bank holding companies are required to maintain Tier 1 Capital of at least 4% of risk-weighted assets and off-balance sheet items, Total Capital (the sum of Tier 1 Capital and Tier 2 Capital) of at least 8% of risk-weighted assets and off-balance sheet items, and Tier 1 Capital of at least 3% of adjusted quarterly average assets. Pursuant to the terms of the SSB MOU, Sterling Savings Bank is required to maintain a Tier 1 Capital level of at least 8%.

Under FDIC regulations, all insured depository institutions are assigned to one of the following capital categories:

Well-Capitalized A well-capitalized insured depository institution: (1) has a total risk-based capital ratio of 10% or greater, (2) has a Tier 1 risk-based capital ratio of 6% or greater, (3) having a leverage capital ratio of 5% or greater, and (4) is not subject to any order or written directive to meet and maintain a specific capital level for any capital measure.

Adequately Capitalized An adequately capitalized insured depository institution: (1) has a total risk-based capital ratio of 8% or greater, (2) has a Tier 1 risk-based capital ratio of 4% or greater, and (3) has a leverage capital ratio of 4% or greater or a leverage capital ratio of 3% or greater if the institution is rated composite 1 under the CAMELS (Capital, Assets, Management, Earnings, Liquidity and Sensitivity to market risk) rating system.

Undercapitalized An undercapitalized insured depository institution: (1) has a total risk-based capital ratio of less than 8%, (2) has a Tier 1 risk-based capital ratio of less than 4%, or (3) has a leverage capital ratio of less than 4%, or if the institution is rated a composite 1 under the CAMELS rating system, a leverage capital ratio of less than 3%.

Significantly Undercapitalized A significantly undercapitalized insured depository institution: (1) has a total risk-based capital ratio of less than 6%, (2) has a Tier 1 risk-based capital ratio of less than 3%, or (3) a leverage capital ratio of less than 3%.

Critically Undercapitalized A critically undercapitalized institution: has a ratio of tangible equity to total assets that is equal to or less than 2%.

The regulations permit the appropriate federal banking regulator to downgrade an institution to the next lower category if the regulator determines (1) after notice and opportunity for hearing or response, that the institution is in an unsafe or unsound condition or (2) that the institution has received and not corrected a less-than-satisfactory rating for any of the categories of asset quality, management, earnings or liquidity in its most recent examination. Supervisory actions by the appropriate federal banking regulator depend upon an institution s classification within the five categories. For the purposes of these tests, Tier 1 Capital generally consists of common equity, retained earnings and a limited amount of qualifying preferred stock, less goodwill and certain core deposit intangibles. Tier 2 Capital consists of non-qualifying preferred stock, certain types of debt and a limited amount of other items. The regulations require certain items, such as goodwill, to be deducted when calculating certain capital requirements.

In measuring the adequacy of capital, assets are generally weighted for risk at rates that range from zero percent to 100%. Certain assets, such as cash and U.S. government securities, have a zero percent risk weighting. Others, such as certain commercial and consumer loans, have a 100% risk weighting. Risk weightings are also assigned for off-balance sheet items such as loan commitments. The various items are multiplied by the appropriate risk-weighting to determine risk-adjusted assets for the capital calculations. For the leverage ratio mentioned above, assets are not risk-weighted.

On September 12, 2010, the Basel Committee announced new capital standards commonly referred to as Basel III. The standards would, among other things, impose more restrictive eligibility

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requirements for Tier 1 and Tier 2 capital; increase the minimum Tier 1 common equity ratio to 4.5%, net of regulatory deductions, and introduce a capital conservation buffer of an additional 2.5% of common equity to risk-weighted assets, raising the target minimum common equity ratio to 7%; increase the minimum Tier 1 capital ratio to 8.5% inclusive of the capital conservation buffer; increase the minimum total capital ratio to 10.5% inclusive of the capital buffer; and introduce a countercyclical capital buffer of up to 2.5% of common equity or other fully loss absorbing capital for periods of excess credit growth. Basel III also introduces a non-risk adjusted Tier 1 leverage ratio of 3%, based on a measure of total exposure rather than total assets, and new liquidity standards. If adopted in the U.S., these standards could lead to significantly higher capital requirements, higher capital charges and more restrictive leverage and liquidity ratios. See Risk Factors We may be subject to more stringent capital requirements.

As of December 31, 2010, as a result of the recently completed Recapitalization Transactions, Sterling and Sterling Savings Bank s capital levels were above those currently required to be deemed well-capitalized. As noted, capital requirements will likely be increasing gradually over the next several years as a result of the implementation of the Dodd-Frank Act and the U.S. federal banking regulators implementation of the recently announced Basel III standards. If a depository institution fails to remain well-capitalized, it becomes subject to a variety of enforcement remedies that increase as the capital condition worsens. See Prompt Corrective Action below.

Commitments to Subsidiary Bank. Under Federal Reserve policy, as well as pursuant to the Reserve Bank Agreement, we are expected to act as a source of financial strength to our subsidiary bank and to commit resources to support our subsidiary bank in circumstances when we might not do so absent such policy. The Dodd-Frank Act requires this Federal Reserve policy to be made law. Under the BHCA, the Federal Reserve may require a bank holding company to terminate any activity or relinquish control of a nonbank subsidiary, other than a nonbank subsidiary of a bank, upon the Federal Reserve s determination that such activity or control constitutes a serious risk to the financial soundness or stability of any depository institution subsidiary. Further, the Federal Reserve has discretion to require a bank holding company to divest itself of any bank or nonbank subsidiaries if the agency determines that any such divestiture may aid the depository institution s financial condition. In addition, any capital loans by us to our subsidiary bank would be subordinate in right of payment to depositors and to certain other indebtedness of Sterling Savings Bank.

If Sterling were to enter bankruptcy, any commitment by it to a federal bank regulatory agency to maintain the capital of Sterling Savings Bank would generally be assumed by the bankruptcy trustee and entitled to a priority of payment. However, recent case law has held that, under certain circumstances, the assumption by the trustee and the priority of payment may be disallowed. It is not clear what impact, if any, this case law would have on our obligations.

Prompt Corrective Action. The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) established a system of prompt corrective action to resolve the problems of undercapitalized insured depository institutions. Under this system, the federal banking regulators are required to rate insured depository institutions on the basis of five capital categories as described above under Capital Requirements. The federal banking regulators are also required to take mandatory supervisory actions and are authorized to take other discretionary actions with respect to insured depository institutions in the three undercapitalized categories, the severity of which will depend upon the capital category in which the insured depository institution is assigned. Generally, subject to a narrow exception, FDICIA requires the banking regulators to appoint a receiver or conservator for an insured depository institution that is critically undercapitalized. The federal banking agencies have specified by regulation the relevant capital level for each category.

FDICIA generally prohibits a depository institution from making any capital distribution, including payment of a dividend, or paying any management fee to its holding company if the depository institution would thereafter be undercapitalized. See Dividends. Undercapitalized depository institutions are also subject to restrictions on borrowing from the Federal Reserve System, may not

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accept brokered deposits absent a waiver from the FDIC, and are subject to growth limitations. In addition, a depository institution s holding company must guarantee a capital plan, up to an amount equal to the lesser of 5% of the depository institution s assets at the time it becomes undercapitalized or the amount of the capital deficiency when the institution fails to comply with the plan. Federal banking agencies may not accept a capital plan without determining, among other things, that the plan is based on realistic assumptions and is likely to succeed in restoring the depository institution s capital. If a depository institution fails to submit an acceptable plan, it is treated as if it is significantly undercapitalized.

Significantly undercapitalized depository institutions may be subject to a number of requirements and restrictions, including orders to sell sufficient voting stock to become adequately capitalized, requirements to reduce total assets, and cessation of receipt of deposits from correspondent banks. Critically undercapitalized institutions are subject to the appointment of a receiver or conservator.

Washington state law gives the WDFI powers similar to those granted to the FDIC under the prompt corrective action provisions of FDICIA.

Dividends. Sterling is a legal entity separate and distinct from Sterling Savings Bank and other subsidiaries. The principal source of funds for our payment of dividends on our common and preferred stock and principal and interest on our debt is dividends from our subsidiaries. Various federal and state statutory provisions and regulations limit the amount of dividends Sterling, Sterling Savings Bank and certain other subsidiaries may pay without regulatory approval.

Pursuant to the Reserve Bank Agreement, Sterling is prohibited from paying any dividends without the prior written approval of the Reserve Bank. Sterling is also prohibited from directly or indirectly taking dividends, or any other form of payment that would represent a reduction in capital from our banking subsidiary without the prior written approval of the Reserve Bank.

Under the Federal Reserve guidance reissued on February 24, 2009 the Federal Reserve may restrict Sterling s ability to pay dividends on any class of capital stock or any other Tier 1 capital instrument if it is not deemed to have a strong capital position. In addition, dividends may have to be reduced or eliminated if:

- Sterling s net income available to shareholders for the past four quarters, net of dividends previously paid during that period, is not sufficient to fully fund the dividends;

- Sterling Savings Bank s prospective rate of earnings retention is not consistent with the holding company s capital needs and overall current and prospective financial condition; or

- Sterling will not meet, or is in danger of not meeting, Sterling s minimum regulatory capital adequacy ratios.

Federal bank regulatory agencies have the authority to prohibit Sterling Savings Bank from engaging in unsafe or unsound practices in conducting its business, and the payment of dividends, depending on the bank s financial condition, could be deemed an unsafe or unsound practice. Pursuant to the SSB MOU, Sterling Savings Bank is prohibited from paying dividends without the prior written consent of the FDIC and the WDFI. The ability of Sterling Savings Bank to pay dividends in the future will continue to be influenced by bank regulatory policies and capital guidelines.

FDICIA generally prohibits a depository institution from making any capital distribution, including payment of a dividend, or paying any management fee to its holding company if the institution would thereafter be undercapitalized. In addition, federal and state banking regulations applicable to us and our bank subsidiaries require minimum levels of capital that limit the amounts available for payment of dividends.

Under the terms of Sterling s junior subordinated notes and the trust documents relating to its junior subordinated debentures, Sterling is allowed to defer payments of interest for up to 20 consecutive quarterly periods without default. During the deferral period, however, Sterling generally may not pay cash dividends on or repurchase common stock, until all accrued interest payments are paid and regularly scheduled interest payments are resumed. We are currently, and expect to continue to be, in

deferral on the payment of interest relating to the junior subordinated debentures and will therefore be unable to pay cash dividends on common stock or preferred stock in the foreseeable future. Pursuant to the terms of the Treasury Exchange, subject to certain exceptions, we will be unable to pay cash dividends on common stock without the Treasury s consent until the earlier of December 5, 2011, or such time as the Treasury ceases to own any debt or equity securities acquired pursuant to the Exchange Agreement or the Treasury Warrant. See Dividend Policy below.

Deposit Insurance and Assessments. Deposits held by Sterling Savings Bank are insured by the Deposit Insurance Fund (the DIF) as administered by the FDIC. The Dodd-Frank Act raised the standard maximum deposit insurance amount to $250,000 per depositor, per insured depository institution for each account ownership category. The change makes permanent the temporary coverage limit increase from $100,000 to $250,000 that had been in effect since October 2008.

In November 2008, the FDIC expanded deposit insurance limits for qualifying transaction accounts under the Transaction Account Guarantee (TAG) program. The TAG program continued until the end of 2010. Under it, noninterest-bearing transaction accounts and qualified NOW checking accounts at Sterling Savings Bank were fully guaranteed by the FDIC for an unlimited amount of coverage. Effective December 31, 2010, and continuing through December 31, 2012, the Dodd-Frank Act provides unlimited FDIC insurance for noninterest-bearing transaction accounts in all banks. The new, two-year coverage picks up where the TAG program left off, though some accounts that were covered under the TAG program, such as NOW checking accounts, will not benefit from the coverage extension.

The FDIC maintains the DIF by assessing each depository institution an insurance premium. The amount of the FDIC assessments paid by a DIF member institution is based on its relative risk of default as measured by the company s FDIC supervisory rating, and other various measures, such as the level of brokered deposits, secured debt and debt issuer ratings.

The DIF assessment base rate currently ranges from 12 to 45 basis points for institutions that do not trigger factors for brokered deposits and unsecured debt, and higher rates for those that do trigger those risk factors. In February 2011, the FDIC redefined the deposit insurance assessment base, and updated the assessment rates. Sterling is currently evaluating these changes and the impact on Sterling is not yet clear. See Risk Factors.

The Dodd-Frank Act effects further changes to the law governing deposit insurance assessments. There is no longer an upper limit for the reserve ratio designated by the FDIC each year, and the maximum reserve ratio may not be less than 1.35% of insured deposits, or the comparable percentage of the assessment base. Under prior law the maximum reserve ratio was 1.15%. The Dodd-Frank Act permits the FDIC until September 30, 2020 to raise the reserve ratio, which is currently negative, to 1.35%. The FDIC is required to offset the effect of increased assessments necessitated by the Dodd-Frank Act on insured depository institutions with total consolidated assets of less than $10 billion, but we cannot currently predict how this offset will affect us, and implementing rules are not expected until mid-2011. See Risk Factors Recent changes have created regulatory uncertainty and Risk Factors Current and future increases in FDIC insurance premiums, including FDIC special assessments imposed on all FDIC-insured institutions, will decrease our earnings. The Dodd-Frank Act also eliminates requirements under prior law that the FDIC pay dividends to member institutions if the reserve ratio exceeds certain thresholds, and the FDIC has proposed that in lieu of dividends, it will adopt lower rate schedules when the reserve ratio exceeds certain thresholds.

All FDIC-insured depository institutions must pay an annual assessment to provide funds for the payment of interest on bonds issued by the Financing Corporation, a federal corporation chartered under the authority of the Federal Housing Finance Board. The bonds, which are referred to as FICO bonds, were issued to capitalize the Federal Savings and Loan Insurance Corporation. FDIC-insured depository institutions paid between 1.02 cents to 1.14 cents per $100 of DIF-assessable deposits in 2009, and between 1.04 to 1.06 cents during 2010.

Transactions with Affiliates and Insiders. A variety of legal limitations restrict Sterling Savings Bank from lending or otherwise supplying funds or

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in some cases transacting business with Sterling or its nonbank subsidiaries. Sterling Savings Bank is subject to Sections 23A and 23B of the Federal Reserve Act and Federal Reserve Regulation W. Section 23A places limits on the amount of covered transactions which include loans or extensions of credit to, investments in or certain other transactions with, affiliates as well as the amount of advances to third parties collateralized by the securities or obligations of affiliates. The aggregate of all covered transactions is limited to 10% of the bank s capital and surplus for any one affiliate and 20% for all affiliates. Furthermore, within the foregoing limitations as to amount, each covered transaction must meet specified collateral requirements ranging from 100% to 130%. Also, banks are prohibited from purchasing low quality assets from an affiliate.

Section 23B, among other things, prohibits an institution from engaging in certain transactions with affiliates unless the transactions are on terms substantially the same, or at least as favorable to the bank, as those prevailing at the time for comparable transactions with nonaffiliated companies. Except for limitations on low quality asset purchases and transactions that are deemed to be unsafe or unsound, Regulation W generally excludes affiliated depository institutions from treatment as affiliates. Transactions between a bank and any of its subsidiaries that are engaged in certain financial activities may be subject to the affiliated transaction limits. The Federal Reserve also may designate bank subsidiaries as affiliates.

Banks are also subject to quantitative restrictions on extensions of credit to executive officers, directors, principal shareholders, and their related interests. In general, such extensions of credit (1) may not exceed certain dollar limitations, (2) must be made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with third parties and (3) must not involve more than the normal risk of repayment or present other unfavorable features. Certain extensions of credit also require the approval of a bank s board of directors.

The Dodd-Frank Act expands the 23A and 23B affiliate transaction rules. Among other things, upon the statutory changes effective date, which will likely be mid- to late- 2012, the scope of the definition of covered transaction under 23A will expand, collateral requirements will increase and certain exemptions will be eliminated.

Standards for Safety and Soundness. The Federal Deposit Insurance Act requires the federal bank regulatory agencies to prescribe, by regulation or guideline, operational and managerial standards for all insured depository institutions relating to: (1) internal controls; (2) information systems and audit systems; (3) loan documentation; (4) credit underwriting; (5) interest rate risk exposure; and (6) asset quality.

The agencies also must prescribe standards for earnings, and stock valuation, as well as standards for compensation, fees and benefits. The federal banking agencies have adopted regulations and Interagency Guidelines Prescribing Standards for Safety and Soundness to implement these required standards. These guidelines set forth the safety and soundness standards used to identify and address problems at insured depository institutions before capital becomes impaired. Under the regulations, if a regulator determines that a bank fails to meet any standards prescribed by the guidelines, the regulator may require the bank to submit an acceptable plan to achieve compliance, consistent with deadlines for the submission and review of such safety and soundness compliance plans.

Regulatory Examination. Federal and state banking agencies require Sterling and Sterling Savings Bank to prepare annual reports on financial condition and to conduct an annual audit of financial affairs in compliance with minimum standards and procedures. Sterling and Sterling Savings Bank must undergo regular on-site examinations by the appropriate banking agency. A bank regulator conducting an examination has complete access to the books and records of the examined institution. The results of the examination are confidential. The cost of examinations may be assessed against the examined institution as the agency deems necessary or appropriate. The FDIC has developed a method for insured depository institutions to provide supplemental disclosure of the estimated fair market value of assets and liabilities, to the extent feasible and practicable, in any balance sheet, financial statement, report of condition or any other report.

State Law and Regulation. Sterling Savings Bank as a Washington state-chartered institution, is subject to regulation by the WDFI, which conducts regular examinations to ensure that its operations and policies conform with applicable law and safe and sound banking practices. Among other things, state law regulates the amount of credit that can be extended to any one borrower and the amount of money that can be invested in various types of assets. Sterling Savings Bank generally cannot extend credit to any one borrower in an amount greater than 20% of Sterling Savings Bank s capital and surplus. State law also regulates the types of loans Sterling Savings Bank can make. With the WDFI s approval, Sterling Savings Bank can currently invest up to 10% of its total assets or 50% of its net worth (whichever is less) in other corporations, whether or not such corporations are engaged in activities related to Sterling Savings Bank s business, but such authority is subject to restrictions imposed by federal law. Sterling Savings Bank also operates depository branches within the states of Oregon, Idaho, California and Montana and therefore its operations in these states are subject to the supervision of the Oregon Department of Consumer and Business Services, the Idaho Department of Finance, the California Department of Financial Institutions and the Montana Department of Finance, as applicable. Sterling and its subsidiaries are also required to comply with applicable laws and regulations for activities in Alaska, Arizona, Colorado, Hawaii, Nevada, Texas and Utah.

Community Reinvestment Act. The Community Reinvestment Act (the CRA) requires that the appropriate federal bank regulator evaluate the record of our banking subsidiary in meeting the credit needs of its local community, including low and moderate income neighborhoods. These evaluations are considered in evaluating mergers, acquisitions, and applications to open a branch or facility. Failure to adequately meet these criteria could result in additional requirements and limitations on the bank. As of Sterling s last CRA regulatory exam, Sterling Savings Bank received a rating of satisfactory.

Consumer Protection Regulations. Retail activities of banks are subject to a variety of statutes and regulations designed to protect consumers. The Dodd-Frank Act creates a Bureau of Consumer Financial Protection that, together with the statute s other enhancements to consumer protection laws such as limits on debit card interchange fees and provisions on mortgage-related matters, will likely increase the compliance costs of consumer banking operations. Interest and other charges collected or contracted for by banks are subject to state usury laws and federal laws concerning interest rates. Loan operations are also subject to federal laws applicable to credit transactions, such as:

- the federal Truth-In-Lending Act and Regulation Z issued by the Federal Reserve, governing disclosures of credit terms to consumer borrowers;
- the Home Mortgage Disclosure Act and Regulation C issued by the Federal Reserve, requiring financial institutions to provide information to enable the public and public officials to determine whether a financial institution is fulfilling its obligation to help meet the housing needs of the community it serves;
- the Equal Credit Opportunity Act and Regulation B issued by the Federal Reserve, prohibiting discrimination on the basis of race, creed or other prohibited factors in extending credit;
- the Fair Credit Reporting Act and Regulation V issued by the Federal Reserve, governing the use and provision of information to consumer reporting agencies;
- the Fair Debt Collection Act, governing the manner in which consumer debts may be collected by collection agencies; and
- the guidance of the various federal agencies charged with the responsibility of implementing such federal laws.

Deposit operations also are subject to:

- the Truth in Savings Act and Regulation DD issued by the Federal Reserve, which requires disclosure of deposit terms to consumers;

Regulation CC issued by the Federal Reserve, which relates to the availability of deposit funds to consumers;

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- the Right to Financial Privacy Act, which imposes a duty to maintain the confidentiality of consumer financial records and prescribes procedures for complying with administrative subpoenas of financial records; and

- the Electronic Funds Transfer Act and Regulation E issued by the Federal Reserve, which governs automatic deposits to and withdrawals from deposit accounts and customers rights and liabilities arising from the use of automated teller machines and other electronic banking services.

Commercial Real Estate Lending. Lending operations that involve concentrations of commercial real estate loans are subject to enhanced scrutiny by federal banking regulators. The regulators have advised financial institutions of the risks posed by commercial real estate lending concentrations. Such loans generally include land development, construction loans and loans secured by multifamily property, and nonfarm, nonresidential real property where the primary source of repayment is derived from rental income associated with the property. The guidance prescribes the following guidelines for examiners to help identify institutions that are potentially exposed to excessive concentration risk and may warrant greater supervisory scrutiny:

- total reported loans for construction, land development and other land represent 100% or more of the institutions total risk-based capital (ratio was 64% for Sterling Savings Bank at December 31, 2010, compared with 271% at December 31, 2009), or

- total commercial real estate loans, as defined, represent 300% or more of the institution s total risk-based capital (ratio was 238% for Sterling Savings Bank at December 31, 2010, compared with 636% at December 31, 2009), and the outstanding balance of the institution s commercial real estate loan portfolio has increased by 50% or more during the prior 36 months.

In October 2009, the federal banking agencies issued additional guidance on commercial real estate lending that reinforces these considerations.

The Dodd-Frank Act contains provisions on credit risk retention that require federal banking regulators to adopt regulations mandating the retention of 5% of the credit risk of assets transferred, sold or conveyed through issuances of asset-backed securities. Implementing regulations will provide for the allocation of the risk retention obligation between securitizers and originators of loans, including residential and commercial mortgages.

Branching. The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (the Interstate Act) permits nationwide interstate banking and branching under certain circumstances. This legislation generally authorizes interstate branching and relaxes federal law restrictions on interstate banking. Currently, bank holding companies may purchase banks in any state, and states may not prohibit these purchases. Additionally, banks are permitted to merge with banks in other states, as long as the home state of neither merging bank has opted out under the legislation. The Interstate Act requires regulators to consult with community organizations before permitting an interstate institution to close a branch in a low-income area.

Washington enacted opting in legislation in accordance with the Interstate Act, allowing banks to engage in interstate merger transactions, subject to certain aging requirements. Once an out-of-state bank has acquired a bank within the state, either through merger or acquisition of all or substantially all of the bank s assets, the out-of-state bank may open additional branches within the state. In addition, an out-of-state bank may establish a de novo branch in Washington or acquire a branch in Washington if the out-of-state bank s home state gives Washington banks substantially the same or more favorable rights to establish and maintain branches in that state.

Anti-Tying Restriction. In general, a bank may not extend credit, lease, sell property, or furnish any services or fix or vary the consideration for products and services on the condition that (1) the customer obtain or provide some additional credit, property, or services from or to the bank or bank holding company or their subsidiaries, or (2) the customer not obtain some other credit, property, or services from a competitor, except to the extent reasonable conditions are imposed to assure the soundness of the credit extended. A bank may, however, offer combined-balance products and may otherwise offer

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more favorable terms if a customer obtains two or more traditional bank products. Also, certain foreign transactions are exempt from the general rule.

Anti-Money Laundering. Financial institutions must maintain anti-money laundering programs that include established internal policies, procedures, and controls; a designated compliance officer; an ongoing employee training program; and testing of the program by an independent audit function. We are prohibited from entering into specified financial transactions and account relationships and must meet enhanced standards for due diligence in dealings with foreign financial institutions and foreign customers. We also must take reasonable steps to conduct enhanced scrutiny of account relationships to guard against money laundering and to report any suspicious transactions. Recent laws provide law enforcement authorities with increased access to financial information maintained by banks. Anti-money laundering obligations have been substantially strengthened as a result of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the USA Patriot Act), enacted in 2001, renewed in 2006 and extended, in part, in 2011. Bank regulators routinely examine institutions for compliance with these obligations and are required to consider compliance in connection with the regulatory review of applications.

The USA Patriot Act amended, in part, the Bank Secrecy Act and provides for the facilitation of information sharing among governmental entities and financial institutions for the purpose of combating terrorism and money laundering. The statute also creates enhanced information collection tools and enforcement mechanics for the U.S. government, including: (1) requiring standards for verifying customer identification at account opening; (2) promulgating rules to promote cooperation among financial institutions, regulators, and law enforcement entities in identifying parties that may be involved in terrorism or money laundering; (3) requiring reports by nonfinancial trades and businesses filed with the Treasury s Financial Crimes Enforcement Network for transactions exceeding $10,000; and (4) mandating the filing of suspicious activities reports if a bank believes a customer may be violating U.S. laws and regulations. The statute also requires enhanced due diligence requirements for financial institutions that administer, maintain, or manage private bank accounts or correspondent accounts for non-U.S. persons.

The Federal Bureau of Investigation may send bank regulatory agencies lists of the names of persons suspected of involvement in terrorist activities. Sterling may be subject to a request for a search of its records for any relationships or transactions with persons on those lists and may be required to report any identified relationships or transactions. Furthermore, the Office of Foreign Assets Control (OFAC) is responsible for helping to ensure that U.S. entities do not engage in transactions with certain prohibited parties, as defined by various Executive Orders and Acts of Congress. OFAC has sent, and will send, bank regulatory agencies lists of names of persons and organizations suspected of aiding, harboring or engaging in terrorist acts, known as Specially Designated Nationals and Blocked Persons. If we find a name on any transaction, account or wire transfer that is on an OFAC list, we must freeze such account, file a suspicious activity report and notify the appropriate authorities.

Privacy and Credit Reporting. Financial institutions are required to disclose their policies for collecting and protecting confidential customer information. Customers generally may prevent financial institutions from sharing nonpublic personal financial information with nonaffiliated third parties, with some exceptions, such as the processing of transactions requested by the consumer. Financial institutions generally may not disclose certain consumer or account information to any nonaffiliated third party for use in telemarketing, direct mail marketing or other marketing. Federal and state banking agencies have prescribed standards for maintaining the security and confidentiality of consumer information, and we are subject to such standards, as well as certain

federal and state laws or standards for notifying consumers in the event of a security breach.

Our banking subsidiary utilizes credit bureau data in underwriting activities. Use of such data is regulated under the Fair Credit Reporting Act and Regulation V on a uniform, nationwide basis, including credit reporting, prescreening, sharing of information between affiliates and the use of credit

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data. The Fair and Accurate Credit Transactions Act, which amended the Fair Credit Reporting Act, permits states to enact identity theft laws that are consistent with the conduct required by the provisions of that Act.

Enforcement Powers. Banks and their institution-affiliated parties, including management, employees, agents, independent contractors and consultants, such as attorneys and accountants and others who participate in the conduct of the institution s affairs, are subject to potential civil and criminal penalties for violations of law, regulations or written orders of a government agency. Violations can include failure to timely file required reports, filing false or misleading information or submitting inaccurate reports. Civil penalties may be as high as $1 million a day for such violations and criminal penalties for some financial institution crimes may include imprisonment for 20 years. Regulators have flexibility to commence enforcement actions against institutions and institution-affiliated parties, and the FDIC has the authority to terminate deposit insurance. When issued by a banking agency, cease-and-desist orders or other regulatory agreements may, among other things, require affirmative action to correct any harm resulting from a violation or practice, including restitution, reimbursement, indemnifications or guarantees against loss. A financial institution may also be ordered to restrict its growth, dispose of certain assets, rescind agreements or contracts, or take other actions determined to be appropriate by the ordering agency. The federal banking agencies also may remove a director or officer from an insured depository institution (or bar them from the industry) if a violation is willful or reckless. The WDFI has similar enforcement powers.

For information on the SSB MOU and the Reserve Bank Agreement applicable to Sterling, see MD&A Regulatory Agreements.

Corporate Governance. The Dodd-Frank Act contains a number of provisions that will require changes to financial institutions corporate governance and executive compensation practices, including proxy access for publicly-traded banks director nominations, clawback of incentive-based compensation from executive officers and increased disclosure on compensation arrangements. Publicly-traded bank holding companies with more than $10 billion in assets will also be required to have risk committees with a number of independent directors to be determined by the Federal Reserve and that include at least one risk management expert with experience in risk management at large, complex companies.

Monetary Policy and Economic Controls. Our earnings are affected by the policies of regulatory authorities, including the monetary policy of the Federal Reserve. An important function of the Federal Reserve is to promote orderly economic growth by influencing interest rates and the supply of money and credit. Among the methods that have been used to achieve this objective are open market operations in U.S. government securities, changes in the discount rate for bank borrowings, expanded access to funds for nonbanks and changes in reserve requirements against bank deposits. These methods are used in varying combinations to influence overall growth and distribution of bank loans, investments and deposits, interest rates on loans and securities, and rates paid for deposits. In recent years, in response to the financial crisis, the Federal Reserve has created several innovative programs to stabilize certain financial institutions and to ensure the availability of credit. The effects of the various Federal Reserve policies on our future business and earnings cannot be predicted.

Depositor Preference Statute. Federal law provides that deposits and certain claims for administrative expenses and employee compensation against an insured depository institution are afforded priority over other general unsecured claims against such institution, including federal funds and letters of credit, in the liquidation or other resolution of the institution by any receiver.

Troubled Asset Relief Program (TARP) Regulations. Under the Emergency Economic Stabilization Act of 2008 (EESA), Congress has the ability to impose after-the-fact terms and conditions on participants in Treasury Department s Capital Purchase Program, a program created to deploy TARP funds. As a participant in the TARP Capital Purchase Program, we are subject to any such retroactive legislation. On February 10, 2009, the Treasury announced the Financial Stability Plan under the EESA, which is intended to further stabilize financial institutions and stimulate lending

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across a broad range of economic sectors. On February 18, 2009, President Obama signed the American Recovery and Reinvestment Act of 2009

(ARRA), a broad economic stimulus package that included additional restrictions on, and potential additional regulation of, financial institutions.

On June 10, 2009, under the authority granted to it under ARRA and EESA, the Treasury Department issued an interim final rule under Section 111 of EESA, as amended by ARRA, regarding compensation and corporate governance restrictions that would be imposed on TARP recipients, effective June 15, 2009. As a TARP recipient with currently outstanding TARP obligations, we are subject to the compensation and corporate governance restrictions and requirements set forth in the interim final rule, which, among other things: (1) prohibit us from paying or accruing bonuses, retention awards or incentive compensation, except for certain long-term stock awards, to our senior executives and next 20 most highly compensated employees; (2) prohibit us from making severance payments to any of our senior executive officers or next five most highly compensated employees; (3) require us to conduct semi-annual risk assessments to assure that our compensation arrangements do not encourage unnecessary and excessive risks or the manipulation of earnings to increase compensation; (4) require us to recoup or clawback any bonus, retention award or incentive compensation paid by us to a senior executive officer or any of our next 20 most highly compensated employees, if the payment was based on financial statements or other performance criteria that are later found to be materially inaccurate; (5) prohibit us from providing tax gross-ups to any of our senior executive officers or next 20 most highly compensated employees; (6) require us to provide enhanced disclosure of perquisites, and the use and role of compensation consultants; (7) required us to adopt a corporate policy on luxury and excessive expenditures; (8) require our chief executive officer and chief financial officer to provide period certifications about our compensation practices and compliance with the interim final rule; (9) require us to provide enhanced disclosure of the relationship between our compensation plans and the risk posed by those plans; and (10) require us to provide an annual non-binding shareholder vote, or say-on-pay proposal, to approve the compensation of our executives, consistent with regulations promulgated by the Securities and Exchange Commission (SEC). On January 12, 2010, the SEC adopted final regulations setting forth the parameters for such say-on pay proposals for public company TARP participants.

We are also obligated under the terms of the Treasury Exchange to take all necessary actions to comply with the executive compensation restrictions under EESA and any subsequent amendments thereto for so long as we remain subject to such restrictions. The Exchange Agreement further requires that we obtain a waiver with respect to the application of the executive compensation restrictions under EESA from each employee who is subject to the restrictions. The Exchange Agreement also reiterates the $500,000 limitation on the deduction of compensation to our senior executive officers under EESA, ARRA and the regulations promulgated thereunder. Finally, if any payments are made that are in violation these Exchange Agreement provisions, such amounts must be subject to clawback and repayment to Sterling, and Sterling must provide notice to Treasury of any violation and clawback that occurs.

Additional regulations applicable to TARP recipients adopted as part of EESA, the Financial Stability Plan, ARRA or other legislation may subject us to additional regulatory requirements. The impact of these additional requirements may put us at competitive disadvantage in comparison to financial institutions that have either repaid all TARP funds or never accepted TARP funds and may materially adversely affect our business and results of operations.

Environmental Laws. Environmentally related hazards have become a source of high risk and potentially unlimited liability for financial institutions relative to their loans. Environmentally contaminated properties owned by an institution s borrowers may result in a drastic reduction in the value of the collateral securing the institution s loans to such borrowers, high environmental clean-up costs to the borrower affecting its ability to repay the loans, the subordination of any lien in favor of the institution to a state or federal lien securing clean-up costs, and liability to the institution for clean-up costs if it forecloses on the contaminated property or becomes involved in the management of the borrower. To minimize this risk,

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Sterling may require an environmental examination and report with respect to the property of any borrower or prospective borrower if circumstances affecting the property indicate a potential for contamination, taking into consideration the potential loss to the institution in relation to the burdens to the borrower. This examination must be performed by an engineering firm experienced in environmental risk studies and acceptable to the institution, with the costs of such examinations and reports being the responsibility of the borrower. These costs may be substantial and may deter a prospective borrower from entering into a loan

transaction with Sterling. Sterling is not aware of any borrower who is currently subject to any environmental investigation or clean-up proceeding that is likely to have a material adverse effect on the financial condition or results of operations of Sterling.

Forward-Looking Statements

From time to time, Sterling and its senior managers have made and will make forward-looking statements that are not historical facts and that are intended to be covered by the safe harbor for forward-looking statements provided by the Private Securities Litigation Reform Act of 1995. These forward-looking statements may include, but are not limited to, statements about Sterling s plans, objectives, expectations and intentions and other statements contained in this release that are not historical facts and pertain to Sterling s future operating results. When used in this report, the words expects, anticipates, intends, plans, believes, seeks, estimates and similar expressions are generally intended to identi forward-looking statements. We make forward-looking statements regarding projected sources of funds, use of proceeds, availability of acquisition and growth opportunities, ability to repay government funds, payment of dividends, adequacy of our allowance for loan and lease losses and provision for loan and lease losses, our real estate portfolio and subsequent charge-offs. 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.

Actual results may differ materially from the results discussed in these forward-looking statements because such statements are inherently subject to significant assumptions, risks and uncertainties, many of which are difficult to predict and are generally beyond Sterling s control. These include but are not limited to:

- our ability to maintain adequate liquidity;
- our ability to comply with the Reserve Bank Agreement and the SSB MOU;
- our ability to attract and retain deposits and loans;
- demand for financial services in our market areas;
- competitive market pricing factors;
- further deterioration in economic conditions that could result in increased loan and lease losses;
- risks associated with concentrations in real estate-related loans;
- market interest rate volatility;
- stability of funding sources and continued availability of borrowings;

changes in legal or regulatory requirements or the results of regulatory examinations that could restrict growth;

our ability to recruit and retain key management and staff;

risks associated with merger and acquisition integration;

our ability to incur debt on reasonable terms;

regulatory limits on the ability of Sterling Savings Bank to pay dividends to Sterling;

impact of legislative and regulatory change on the financial sector;

future legislative or administrative changes to the TARP Capital Purchase Program; and

the impact of EESA and ARRA and related rules and regulations on Sterling s business operations and competitiveness, including the impact of executive compensation restrictions, which may affect Sterling s ability to retain and recruit executives in competition with other firms who do not operate under those restrictions.

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Other factors that could cause actual conditions, events or results to differ significantly from those described in the forward-looking statements may be found under the headings Risk Factors and Management s Discussion and Analysis of Financial Condition and Results of Operations below, as updated periodically in Sterling s filings with the SEC. Unless legally required, Sterling disclaims any obligation to update any forward-looking statements. You should consider any forward-looking statements in light of this explanation, and we caution you about relying on forward-looking statements.

Where You Can Find More Information

The periodic reports Sterling files with the SEC are available on Sterling s website at www.sterlingfinancialcorporation-spokane.com after the reports are filed with the SEC. The SEC maintains a website located at www.sec.gov that also contains this information. The information on Sterling s website and the SEC s website is not part of this annual report on Form 10-K. **Sterling will provide you with copies of these reports, without charge, upon request made to:**

Investor Relations

Sterling Financial Corporation

111 North Wall Street

Spokane, Washington 99201

(509) 458-3711

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Item 1A. Risk Factors

Set forth below and elsewhere in this Annual Report on Form 10-K and in other documents we file with the SEC are risks and uncertainties that could cause actual results to differ materially from the results contemplated by the forward-looking statements contained in this Annual Report on Form 10-K.

The risks described below are not the only ones facing our company. Additional risks not presently known to us or that we currently deem immaterial may also impair our business operations. Our business, financial condition, results of operations or prospects could be materially and adversely affected by any of these risks. The trading price of, and market for, shares of Sterling common stock could decline due to any of these risks. This report, including the documents incorporated by reference herein, also contain forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factors, including the risks described below and in the documents incorporated by reference herein.

If our current capital levels are not sufficient to satisfy our needs or to satisfy changing regulatory requirements, we may need additional capital and could be subject to further regulatory restrictions, either of which could significantly adversely affect us and the trading price of our stock.

The proceeds from the Recapitalization have been raised to strengthen our common equity capital base. If the proceeds from the Recapitalization prove not to be sufficient, or if economic conditions continue to be difficult or worsen or fail to improve in a timely manner, or if our operations or financial condition deteriorates or fails to improve, particularly in the residential and commercial real estate markets where Sterling operates, there may be a need to raise significant additional capital. Factors affecting whether we would need to raise additional capital include, among others, changing requirements of regulators, additional provisions for loan losses and loan charge-offs and other risks discussed in this Risk Factors section. If we were to need to raise additional capital, we may not be able to do so in the amounts required and in a timely manner, or at all. Our ability to raise additional capital may be constrained by our need to preserve our deferred tax assets. For more information, see Our ability to use our deferred tax assets may be materially impaired below. In addition, any such additional capital raised may be significantly dilutive to our existing shareholders and may result in the issuance of securities that have rights, preferences and privileges that are senior to our common stock.

We may issue securities that could dilute the ownership of our existing shareholders and may adversely affect the market price of our common stock and warrants.

We may decide to raise additional funds through public or private debt or equity financings for a number of reasons, including in response to regulatory or other requirements to meet our liquidity and capital needs as discussed above, to finance our operations and business strategy (including potential acquisitions) or for other reasons. If we raise funds by issuing equity securities or instruments that are convertible into equity securities, the percentage ownership of our existing shareholders will be reduced, the new equity securities may have rights, preferences and privileges superior to those of our common stock and additional issuances could be at a purchase price that is lower than the available market price for our common stock. The Anchor Investors and Private Placement Investors also have pre-emptive rights to maintain their ownership percentages in certain circumstances. In addition, there are anti-dilution adjustments in the warrants issued to the Anchor Investors and the amended warrant issued to Treasury that may protect the holders thereof against below-market issuances. There is generally no such protection available to holders of our common stock. To the extent that any new issuance of equity securities triggers these anti-dilution adjustments, your ownership could be further diluted. Except as described above, holders of our common stock have no pre-emptive rights that entitle them to purchase their pro rata share of any offering of shares of any class or series. The market price of our common stock or our warrants could decline as a result of sales of a large number of shares of common stock, preferred stock or similar securities in the market as a result of future sales of common stock or the perception that such sales

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could occur. We may also issue equity securities as consideration for acquisitions we may make that could be dilutive to existing shareholders.

We cannot determine whether or when certain agreements entered into with our regulators will be lifted.

Following the September 2010 termination of its cease and desist order, Sterling Savings Bank remains subject to enhanced supervisory review on an informal basis in the form of the SSB MOU. Though the requirements of the SSB MOU are less strenuous than were the requirements of the cease and desist order, Sterling Savings Bank is required to maintain Tier 1 capital in an amount that ensures that its leverage ratio is at least 8%. The SSB MOU also requires Sterling Savings Bank to meet certain asset quality targets, develop a written capital plan, develop a three-year strategic plan and accept other limitations.

Under the terms of the Reserve Bank Agreement, Sterling is subject to restrictions on its ability to pay dividends and distributions, incur debt, purchase or redeem stock and appoint new board members or senior executive officers. Under the Reserve Bank Agreement, Sterling is also required to act as a source of strength to Sterling Savings Bank and to report quarterly to the Reserve Bank on steps taken to improve its capital ratios and risk, liquidity and funds management and on other matters.

We cannot determine whether or when the SSB MOU or the Reserve Bank Agreement will be lifted or terminated. Even if the Reserve Bank Agreement is lifted or terminated, Sterling may remain subject to a memorandum of understanding or other undertaking with the Reserve Bank that restricts our activities and continues to impose higher capital ratios, as the SSB MOU does. The requirements and restrictions of the Reserve Bank Agreement are judicially enforceable, and Sterling Savings Bank is obligated to comply with the undertakings set forth in the SSB MOU. The failure to comply with the SSB MOU and the Reserve Bank Agreement may result in the issuance of a new cease and desist order or subject Sterling and Sterling Savings Bank to additional regulatory restrictions including: the imposition of civil monetary penalties; the issuance of directives to increase capital or enter into a strategic transaction, whether by merger or otherwise, with a third party; and other limitations or restrictions on our business or activities.

Acquisitions present many risks, and we may not realize the financial and strategic goals that are contemplated at the time of any future acquisitions.

Our growth strategy includes an intent to acquire other banks. This strategy entails risk. Acquisitions and related transition and integration activities may disrupt our ongoing business and divert management s attention. In addition, an acquisition may not further our corporate strategy as we expected, we may pay more than the acquired banks or assets are ultimately worth or we may not integrate an acquired bank or assets as successfully as we expected, which could adversely affect our business, results of operations and financial condition. We may be adversely affected by liabilities or pre-existing contractual relationships that we assume and may also fail to anticipate or accurately estimate litigation or other exposure, unfavorable accounting consequences, increases in taxes due or a loss of anticipated tax benefits. Other potential adverse consequences include higher than anticipated costs associated with the acquired bank or assets or integration activities. The use of cash to pay for acquisitions may limit our use of cash for other potential activities, such as dividends. The use of equity securities to pay for acquisitions could significantly dilute existing shareholders. If we use debt to finance acquisitions, we may significantly increase our expenses, leverage and debt service requirements. The occurrence of any of these risks could have a material adverse effect on our business, results of operations, financial condition or cash flows, particularly in the case of a large acquisition or several concurrent acquisitions.

Our strategy of pursuing acquisitions of troubled institutions may not be successful.

We anticipate that a part of our future business strategy will be to pursue the acquisition of troubled banks. We are not currently qualified to bid on these transactions. Although we plan to be intensely focused on complying with and being released from the SSB MOU and the Reserve Bank Agreement and becoming qualified to bid on such transactions, we

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may not be successful in the near term or at all. Prolonged or indefinite failure to achieve such qualification could cause us to miss the opportunity to bid on banks that we believe would be attractive acquisition candidates. The bidding process for failing banks has become very competitive, and we may not be able to match or beat the bids of other acquirers unless we bid aggressively by increasing the premium paid on assumed deposits, reducing the discount bid on assets purchased or taking other actions, any of which could make the acquisition less attractive.

The FDIC Policy Statement will limit our ability to acquire failed banks, which may harm our competitive position.

As the agency responsible for resolving failed depository institutions, the FDIC has discretion to determine whether a party is qualified to bid on a failed institution. The FDIC Policy Statement imposes additional restrictions and requirements on certain private investors and institutions, to the extent that those investors or institutions seek to acquire a failed institution from the FDIC. These include, among others, a requirement that certain private investors in those institutions agree to a three-year transfer restriction on their shares. Since its initial adoption on August 26, 2009, the FDIC has issued several interpretations which have modified the Policy Statement and the FDIC may change it in the future. On April 23, 2010, the FDIC issued an interpretation that would permit a recapitalized institution (such as Sterling) to acquire failed banks without being subject to the FDIC Policy Statement, provided the assets of the failed banks acquired during the 18 months following a recapitalization do not exceed 100% of the total assets of the recapitalized institution. It is not clear how the FDIC would calculate percentage of assets, and whether that percentage is based on assets at the time of the Recapitalization or whether the percentage is based on growth or contraction in an institution over time. We do not intend to make any acquisition that would subject us to the FDIC Policy Statement absent the consent of those shareholders to whom the FDIC Policy Statement would apply, and it is possible that any such consent might not be obtained. If we are able to obtain requisite shareholder consent to be bound by the FDIC Policy Statement and we enter into such transactions, our operating flexibility could be harmed by having to comply with the other requirements set forth in the FDIC Policy Statement. On the other hand, if we are not able to pursue transactions that we otherwise believe are attractive, our growth strategy, competitive position, and stock price may be adversely affected.

We could be materially and adversely affected if we or any of our officers or directors fail to comply with bank and other laws and regulations.

As a bank holding company, Sterling is subject to extensive regulation by U.S. federal and state regulatory agencies and face risks associated with investigations and proceedings by regulatory agencies, including those that we may believe to be immaterial. Like any corporation, we are also subject to risk arising from potential employee misconduct, including non-compliance with our policies. Any interventions by authorities may result in adverse judgments, settlements, fines, penalties, injunctions, suspension or expulsion of our officers or directors from the banking industry or other relief. In addition to the monetary consequences, these measures could, for example, impact our ability to engage in, or impose limitations on, certain of our businesses. The number of these investigations and proceedings, as well as the amount of penalties and fines sought, has increased substantially in recent years with regard to many firms in the industry. Significant regulatory action against us or our officers or directors could materially and adversely affect our business, financial condition or results of operations or cause us significant reputational harm, which could seriously harm our business.

Our common stock is equity and is subordinate to our existing and future indebtedness, and our common stock would be subordinate to any future preferred stock.

Shares of our common stock are equity interests in Sterling, do not constitute indebtedness, and, therefore, are not insured against loss by the FDIC or by any other public or private entity. Shares of our common stock will rank junior to all of our indebtedness and to other non-equity claims against us and our assets available to satisfy such claims,

including in liquidation. Our board of directors is authorized to issue additional classes or series of preferred stock without any action on the part of the holders of our common stock, and the holders of our common stock do not have the right to prevent us from incurring indebtedness or other claims.

Resales of our common stock may be impeded by transfer restrictions.

Subject to certain exceptions, our common stock issued in connection with the Recapitalization is subject to transfer restrictions designed to prevent (a) any person from acquiring ownership, for relevant tax purposes, of 5% or more of our shares and (b) the disposition of shares by any person that owns 5% or more of our shares, subject to certain exceptions. These restrictions may adversely affect the ability of certain shareholders to resell our common stock by rendering any transactions in violation of this prohibition void. We have also amended our restated articles of incorporation to impose these transfer restrictions on all holders of our common stock.

In addition, on April 14, 2010, we adopted a shareholder rights plan (the Rights Plan), which is described in our Form 8-K filed on April 15, 2010. In December of 2010, we amended the Rights Plan to extend the expiration of the plan until August 26, 2013. The purpose of the Rights Plan is to minimize the likelihood of an ownership change, as defined in Section 382 of the Code, and thus to protect our ability to use our net operating loss carry-forward and certain built-in losses to offset future income. The Rights Plan provides an economic disincentive for any one person or group to become a Threshold Holder (as defined therein, generally an owner of 5% or more of our stock) and for any existing Threshold Holder to acquire more than a specified amount of additional shares, and so may adversely affect one s ability to resell our common stock and negatively affect the trading price of our common stock.

In addition, shareholders that are not residents of the Republic of Korea, will not be permitted to sell or transfer Sterling shares to a Korean resident until August 26, 2011, and shareholders residing in the Republic of Korea, will not be permitted to sell or transfer Sterling shares to another Korean resident other than a professional investor until August 26, 2011; provided that, in each case, such restrictions shall not apply to open market transactions effected through the New York Stock Exchange or NASDAQ. These restrictions may limit the ability of shareholders to resell Sterling shares.

We are not currently able to pay dividends on our common stock.

Under the terms of our junior subordinated notes and the trust documents relating to our trust preferred securities, Sterling is allowed to defer payments of interest for up to 20 consecutive quarterly periods without default. During the deferral period, however, Sterling may not pay cash dividends on or repurchase common stock, until all accrued interest payments are paid and regularly scheduled interest payments are resumed. Sterling is currently, and expects to continue to be, in deferral on the payment of interest relating to the trust preferred securities and will therefore be unable to pay cash dividends on common stock or preferred stock in the foreseeable future. Pursuant to the terms of the Treasury Exchange, subject to certain exceptions, we will be unable to pay cash dividends on common stock without the Treasury s consent until the earlier of December 5, 2011, or such time as the Treasury ceases to own any debt or equity securities acquired pursuant to the Exchange Agreement or Treasury s warrant. Under the SSB MOU and the Reserve Bank Agreement, we are prohibited from paying dividends without the prior approval of the FDIC, WDFI and the Reserve Bank. See Dividend Policy below.

We may suffer substantial losses due to our agreements to indemnify certain investors against a broad range of potential claims.

In connection with the Recapitalization, we have agreed to indemnify THL, Warburg Pincus, the Private Placement Investors and certain related parties for a broad range of claims, including any inaccuracies or breaches of our representations and warranties in the relevant Recapitalization agreements and any losses arising out of or resulting from any legal, administrative or other proceedings arising out of the transactions contemplated by the relevant Recapitalization agreements and the terms of the securities being offered. While these indemnities are capped at the

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aggregate purchase price of $730 million, if all or some claims were successfully brought against Sterling, it could potentially result in significant losses for Sterling.

As a result of the Recapitalization, THL and Warburg Pincus are substantial holders of our common stock.

Following the closing of the Recapitalization, THL and Warburg Pincus each became beneficial owners of our outstanding common stock, with their respective ownership percentages each equating to approximately 23% as of January 31, 2011, assuming the full exercise of such Anchor Investor s warrant. Each has a representative on our Board of Directors. Accordingly, THL and Warburg Pincus have substantial influence over the election of directors to our board and over corporate policy, including decisions to enter into mergers or other extraordinary transactions. In addition, as part of the negotiations for the Anchor Investments, THL and Warburg Pincus requested, and our board of directors agreed to grant, pre-emptive rights to maintain THL s and Warburg Pincus s fully diluted percentage ownership of our common stock in the event of certain issuances of securities by us. In pursuing its economic interests, THL and Warburg Pincus may make decisions with respect to fundamental corporate transactions that may not be aligned with the interests of other shareholders.

Our stock price has been and may continue to be volatile, which could cause the value of our common stock to decline.

In recent periods, the trading price of our common stock has been and may continue to be highly volatile and subject to wide fluctuations in price. This volatility is in response to various factors, many of which are beyond our control, including:

- actual or anticipated variations in quarterly operating results from historical results or estimates of results prepared by securities analysts;
- announcements of new services or products by us or our competitors;
- announcements by us of significant acquisitions, strategic partnerships, joint ventures or capital commitments;
- conditions or trends in the financial industry;
- additions or departures of key personnel;
- general economic conditions and interest rates;
- the sales and trading volume of our common stock;
- instability in the United States and other financial markets and the ongoing and possible escalation of unrest in the Middle East, other armed hostilities or further acts or threats of terrorism in the United States or elsewhere;
- the potential impact of the secondary trading of our stock on foreign exchanges that are subject to less regulatory oversight than the NASDAQ Capital Market, without our permission, and the activity of the market makers of our stock on such exchanges, including the risk that such market makers may engage in naked short sales and/or other deceptive trading practices that may artificially depress or otherwise affect the price of our common stock on the NASDAQ Capital Market;
- earnings estimates and recommendations of securities analysts;

the performance and stock price of other companies that investors and analysts deem comparable to us;

the soundness or predicted soundness of other financial institutions; and

the public perception of the banking industry and its safety and soundness.

In addition, the stock market in general, and the NASDAQ Capital Market and the market for commercial banks and other financial services companies in particular, has experienced significant price and volume volatility that sometimes have been unrelated or disproportionate to the operating performance of those companies. These broad market and industry factors may seriously harm the market price of our common stock, regardless of our operating performance. In the past, following periods of volatility in the market price of a company s securities, securities class action litigation has often been instituted. Sterling is currently engaged in securities class action litigation, the Employee Retirement Income Security

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Act of 1974, as amended (ERISA) class action litigation, and derivative class action litigation, and these actions or any other suit against us could result in substantial costs, potential liabilities and the diversion of management s attention and resources. As a result of these factors, among others, the value of your investment may decline, and you may be unable to sell your shares of our common stock at or above your purchase price. See Legal Proceedings.

The trading volume of our common stock is lower than that of other financial services companies.

Our common stock is listed on the NASDAQ Capital Market under the symbol STSA. The average daily trading volume for shares of our common stock is lower than larger financial institutions. During the 12 months ended December 31, 2010, the average daily trading volume for our common stock was 27,852 shares. As a result, sales of our common stock may place significant downward pressure on the market price of our common stock. Furthermore, it may be difficult for holders to resell their shares at prices they find attractive, or at all.

Our ability to realize the benefit of our deferred tax assets may be materially impaired.

As of December 31, 2010, our net deferred tax asset was approximately $359 million, which includes approximately $263 million of federal and state net operating losses (NOLs). We currently have a valuation allowance of $359 million against this deferred tax asset. Our ability to use our deferred tax assets to offset future taxable income will be limited if we experience an ownership change as defined in Section 382 of the Code. As a result of the Recapitalization we are now close to the ownership change threshold.

In general, an ownership change will occur if there is a cumulative increase in our ownership by 5-percent shareholders (as defined in the Code) that exceeds 50 percentage points over a rolling three-year period. A corporation that experiences an ownership change will generally be subject to an annual limitation on the use of its pre-ownership change deferred tax assets equal to the equity value of the corporation immediately before the ownership change, multiplied by the applicable long-term tax-exempt rate.

While we have implemented measures to reduce the likelihood that future transactions in our common stock will result in an ownership change, such an ownership change might occur in the future. More specifically, while the Rights Plan we have adopted, as well as the protective amendment to our restated articles of incorporation approved by our shareholders, are intended to discourage or prevent transfers of Sterling shares that would increase a shareholder s ownership to 5% or more of our common stock or that would increase the percentage of our common stock owned by a shareholder already deemed to be a 5-percent shareholder , these restrictions might not deter a shareholder from increasing its ownership interests beyond these limits. Such an increase could adversely affect our ownership change calculations.

Our calculations regarding our current cumulative change and the likelihood of a future ownership change are based on current law. Any change in applicable law may result in an ownership change.

We have incurred significant losses since the fourth quarter of 2008 and may continue do so in the future.

Cumulatively, from the fourth quarter of 2008 through the fourth quarter of 2010, Sterling has incurred a net loss of $1.42 billion, primarily due to a $1.16 billion provision for credit losses, a $451.3 million charge for goodwill impairment and the establishment of a $359.0 million deferred tax asset valuation allowance. In light of the current economic environment, significant additional provisions for credit losses may be necessary to supplement the allowance for credit losses in the future. As a result, we may incur significant credit costs in 2011 and future periods, which would continue to have an adverse impact on our financial condition and results of operations, and could adversely affect the price of, and market for, our common stock.

Our estimated allowance for losses in our loan portfolio may be inadequate, which would cause our results of operations and financial condition to be adversely affected.

We maintain an allowance for credit losses, which is a reserve established through a provision for credit losses charged as an expense and represents

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management s best estimate of incurred losses within our existing portfolio of loans. The level of the allowance reflects management s estimates based upon various assumptions and judgments as to specific credit risks, evaluation of industry concentrations, loan loss experience, current loan portfolio quality, present economic, political and regulatory conditions and unidentified losses inherent in the current loan portfolio. The determination of the appropriate level of the allowance for credit losses inherently involves a high degree of subjectivity and requires management to make significant estimates and judgments regarding current credit risks and future trends, all of which may undergo material changes. If our estimates prove to be incorrect, our allowance for credit losses may not be sufficient to cover losses in our loan portfolio and our expense relating to the additional provision for credit losses could increase substantially. In addition, bank regulatory agencies periodically review the adequacy of our allowance for credit losses as part of their examination process, and may require an increase in the provision for possible credit losses or the recognition of further loan charge-offs. Any such increases in the allowance for credit losses may have a material adverse effect on our results of operations, financial condition and the value of our common stock.

The effects of the current economic recession have been particularly severe in our primary market areas in the Pacific Northwest and California.

Substantially all of our loans are to businesses and individuals in Washington, Oregon, Idaho, Montana and California. The Pacific Northwest and California have some of the nation s highest unemployment rates, and major employers in Washington, Oregon, Idaho and California have recently implemented substantial employee layoffs or scaled back growth plans. Severe declines in housing prices and property values have been particularly acute in our primary market areas, and each state continues to face fiscal challenges, which may have adverse long term effects on the economy of our region. A further deterioration in the economic conditions or a prolonged delay in economic recovery in our primary market areas could result in the following consequences, any of which could materially and adversely affect our business: collateral for loans, especially real estate, may decline further in value, in turn reducing customers borrowing power and further reducing the value of assets and collateral associated with our existing loans; loan delinquencies may increase; problem assets and foreclosures may increase; demand for our products and services may decrease; and access to low cost or noninterest bearing deposits may decrease.

A large percentage of our loan portfolio is secured by real estate. Continued deterioration in the real estate market or other segments of our loan portfolio would lead to additional losses, which could have a material adverse effect on our business, financial condition and results of operations.

Approximately 89% of our loan portfolio was secured by real estate as of December 31, 2010. As a result of increased levels of commercial and consumer delinquencies and declining real estate values, we have experienced increasing levels of net charge-offs and provisions for credit losses. Continued increases in commercial and consumer delinquency levels or continued declines in real estate market values would require increased net charge-offs and increases in the provision for credit losses, which could have a material adverse effect on our business, financial condition and results of operations and prospects. Acts of nature, including earthquakes, floods and fires, which may cause uninsured damage and other loss of value to real estate that secures these loans, may also have a negative impact on our financial condition. In addition, we may face risks associated with our real estate lending under various federal, state and local environmental laws that impose certain requirements on the owner or operator of a property.

A portion of our loan portfolio is secured by non-owner-occupied commercial real estate, which generally involves a higher degree of risk than owner-occupied commercial loans.

At December 31, 2010, approximately 23% of our commercial real estate secured loans were secured by non-owner-occupied commercial real estate. Non-owner-occupied commercial real estate loans generally depend on the cash flow from the property to service the debt. Cash flow may be significantly affected by general economic conditions. Many of

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our non-owner occupied commercial real estate borrowers have more than one loan outstanding with us. Consequently, losses incurred on loans to a small number of borrowers could have a material adverse impact on our income and financial condition.

A rapid change in interest rates could make it difficult to maintain our current net interest income spread and could result in reduced earnings.

Our earnings are largely derived from net interest income, which is interest income earned on loans and investments, less interest paid on deposits and other borrowings. Interest rates are highly sensitive to many factors that are beyond the control of our management, including general economic conditions and the policies of various governmental and regulatory authorities. As interest rates change, net interest income is affected. With fixed rate assets (such as fixed rate loans and most investment securities) and liabilities (such as certificates of deposit), the effect on net interest income depends on the cash flows associated with the maturity of the asset or liability. Asset/liability management policy may not be successfully implemented and from time to time our risk position is not balanced. An unanticipated rapid decrease or increase in interest rates could have an adverse effect on the spreads between the interest rates earned on assets and the rates of interest paid on liabilities, and therefore on the level of net interest income. For instance, any rapid increase in interest rates in the future could result in interest expense increasing faster than interest income because of fixed rate loans and longer-term investments. Further, substantially higher interest rates could reduce loan demand and may result in slower loan growth than previously experienced. This could have an adverse negative effect on our earnings.

Our cost of funds may increase as a result of many factors, which may reduce profitability.

Our cost of funds may increase because of general economic conditions, unfavorable conditions in the capital markets, changes in interest rates, government intervention and support of competitors, government price controls and competitive pressures. We have traditionally obtained funds principally through deposits and, to a lesser extent, other borrowings, including repurchase agreements. As a general rule, deposits are a cheaper and more stable source of funds than borrowings. Checking and savings account balances and other forms of deposits can decrease when our deposit customers perceive alternative investments, such as the stock market or other non-depository investments, as providing superior expected returns, seek to spread their deposits over several banks to maximize FDIC insurance coverage or perceive weakness in our financial stability. Furthermore, technology and other changes have made it more convenient for bank customers to transfer funds into alternative investments, including products offered by other financial institutions or non-bank service providers. Additional increases in short-term interest rates could increase transfers of deposits to higher yielding deposits. Efforts and initiatives we undertake to retain and increase deposits, including deposit pricing, can increase our costs. When bank customers move money out of bank deposits in favor of alternative investments or into higher yielding deposits, or spread their accounts over several banks, we can lose a relatively inexpensive source of funds, thus increasing our funding costs. If, as a result of general economic conditions, market interest rates, competitive pressures or other factors, our level of deposits decreases relative to our overall banking activities, we may need to rely more heavily on borrowings and/or wholesale funding as a source of funds, and this may negatively impact our net interest margin and subject us to additional liquidity and funding risks.

We may have reduced access to wholesale funding sources.

As a part of our liquidity management, we use a number of funding sources in addition to core deposit growth and repayments and maturities of loans and investments. Our financial flexibility will be severely constrained if we are unable to maintain sufficient collateral or access to funding at acceptable interest rates. If we are required to rely more heavily on more expensive funding sources, and our revenues do not increase in proportion with our costs, our profitability will be impacted.

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We are subject to extensive governmental regulation, and further regulatory actions against us may impair our operations or restrict our growth.

Sterling and Sterling Savings Bank are subject to extensive regulation under federal and state laws including those of the Federal Reserve, the FDIC and the WDFI. These laws and regulations are primarily intended to protect customers, depositors and the Deposit Insurance Fund rather than shareholders. In addition, Sterling is subject to regulation and supervision by the Federal Reserve and the SEC and to the listing standards of the NASDAQ Capital Market. Sterling Savings Bank is also subject to the supervision by and the regulations of the FDIC, and the state agencies for the states in which it conducts business. As a Washington state-chartered commercial bank, Sterling Savings Bank is primarily regulated by the WDFI.

Statutes and regulations affecting our business may be changed at any time, and the interpretation of these statutes and regulations by examining authorities may also change. Within the last several years, Congress and the President have passed and enacted significant changes to these statutes and regulations, including most recently, the Dodd-Frank Act signed into law on July 21, 2010. Such changes to the statutes and regulations or to their interpretation may adversely affect our business. In addition to governmental supervision and regulation, we are subject to changes in other federal and state laws, including changes in tax laws, which could materially affect the banking industry. The regulators may continue to limit our activities or growth and may impose monetary penalties, which could severely limit or end certain of our operations. Banking laws and regulations change from time to time. Bank regulations can hinder our ability to compete with financial services companies that are not regulated in the same manner or are less regulated.

Bank regulatory authorities have the authority to bring enforcement actions against banks and bank holding companies for unsafe or unsound practices in the conduct of their businesses or for violations of any law, rule or regulation, any condition imposed in writing by the appropriate bank regulatory agency or any written agreement with the authority.

Recent changes have created regulatory uncertainty.

Regulation of the financial services industry is undergoing major changes. The Dodd-Frank Act significantly revises and expands the rulemaking, supervisory and enforcement authority of federal bank regulators. Although the statute will have a greater impact on larger institutions than regional bank holding companies such as Sterling, many of its provisions will apply to us. Among other things, the Dodd-Frank Act:

- is changing the capital requirements for bank holding companies and would require less favorable capital treatment for future issuances of trust preferred (although our existing trust preferred are grandfathered and therefore not subject to the new rules);

- raises prudential standards by requiring, for instance, annual internal stress testing and establishment of independent risk committees for banks with $10 billion or more in assets;

- grants the FDIC back-up supervisory authority with respect to depository institution holding companies that engage in conduct that poses a foreseeable and material risk to the Deposit Insurance Fund, and heightens the Federal Reserve s authority to examine, prescribe regulations and take action with respect to all subsidiaries of a bank holding company;

- prohibits insured state-chartered banks from engaging in derivatives transactions unless the chartering state s lending limit laws take into consideration credit exposure to derivative transactions;

- specifies that a bank holding company may acquire control of an out-of-state bank only if it is well-capitalized and well-managed, and does not allow interstate merger transactions unless the resulting bank would be well-capitalized and well-managed after the transaction;

changes how the FDIC calculates deposit insurance assessments and effectively requires increases in deposit insurance fees that will be borne primarily by institutions with assets of greater than $10 billion;

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- subjects both large and small financial institutions to data and information gathering by a newly created Office of Financial Research;

- requires retention of 5% of the credit risk in assets transferred, sold or conveyed through issuances of asset-backed securities, with the risk-retention obligation spread between securitizers and originators;

- creates a new Consumer Bureau given rulemaking, examination and enforcement authority over consumer protection matters, imposes limits on debit card interchange fees that may be charged by card issuers with $10 billion or more in assets and contains provisions on mortgage-related matters such as steering incentives, determinations as to a borrowers ability to repay and prepayment penalties; and

- mandates and allows certain changes regarding corporate governance and executive compensation such as shareholder proxy access for publicly traded banks director nominations, clawback of incentive-based compensation from executive officers and increased disclosure on compensation arrangements.

Some of these changes are effective immediately, though most will be phased in gradually. In addition, the statute in many instances calls for future rulemaking to implement its provisions, so the precise contours of the law and its effects on us cannot yet be fully understood. The provisions of the Dodd-Frank Act and the subsequent exercise by regulators of their revised and expanded powers thereunder could materially impact the profitability of our business, the value of assets we hold or the collateral available for our loans, require changes to business practices or force us to discontinue businesses and expose us to additional costs, taxes, liabilities, enforcement actions and reputational risk. Legislators and regulators are also considering a wide range of proposals beyond the Dodd-Frank Act that, if enacted, could result in major changes to the way banking operations are regulated.

We may be subject to more stringent capital requirements.

As discussed above, the Dodd-Frank Act would require the federal banking agencies to establish stricter risk-based capital requirements and leverage limits to apply to banks and bank holding companies. In addition, the Basel III standards recently announced by the Basel Committee on Banking Supervision (the Basel Committee), if adopted, could lead to significantly higher capital requirements, higher capital charges and more restrictive leverage and liquidity ratios. The standards would, among other things, impose more restrictive eligibility requirements for Tier 1 and Tier 2 capital; increase the minimum Tier 1 common equity ratio to 4.5%, net of regulatory deductions, and introduce a capital conservation buffer of an additional 2.5% of common equity to risk-weighted assets, raising the target minimum common equity ratio to 7%; increase the minimum Tier 1 capital ratio to 8.5% inclusive of the capital conservation buffer; increase the minimum total capital ratio to 10.5% inclusive of the capital buffer; and introduce a countercyclical capital buffer of up to 2.5% of common equity or other fully loss absorbing capital for periods of excess credit growth. Basel III also introduces a non-risk adjusted Tier 1 leverage ratio of 3%, based on a measure of total exposure rather than total assets, and new liquidity standards.

The new Basel III capital standards will be phased in from January 1, 2013 until January 1, 2019, and it is not yet known how these standards will be implemented by U.S. regulators generally or how they will be applied to financial institutions of our size. Implementation of these standards, or any other new regulations, may adversely affect our ability to pay dividends, or require us to restrict growth or raise capital, including in ways that may adversely affect our results of operations or financial condition.

Difficult market conditions have adversely affected and may continue to have an adverse effect on our industry.

The capital and credit markets have been experiencing difficulty for more than three years. Dramatic declines in the housing market over the past three years, with falling home prices and increasing foreclosures, unemployment and under-employment, have had a negative impact on the performance of mortgage loans and have resulted in significant write-downs of asset values by financial institutions, including government-sponsored entities as well as major commercial and investment banks. These write-downs have caused many financial institutions to seek additional capital, to

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merge with larger and stronger institutions and, in some cases, to fail. Reflecting concern about the stability of the financial markets generally and the strength of counterparties, many lenders and institutional investors have reduced or ceased providing funding to borrowers, including to other financial institutions. This market turmoil and tightening of credit have led to an increased level of commercial and consumer delinquencies, lack of consumer confidence, increased market volatility and widespread reduction of business activity generally. The resulting economic pressure on consumers and lack of confidence in the financial markets has adversely affected our business, financial condition and results of operations. We expect that the difficult conditions in the financial markets will improve only slowly in the near future. A worsening of these conditions would likely exacerbate the adverse effects of these difficult market conditions on us and others in the financial institutions industry. In particular, we may face the following risks in connection with these events:

- While increased regulation and enforcement is now certain in the financial sector, with increased compliance costs, the scope of such regulation is uncertain, and that uncertainty affects our business opportunities and plans.

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

- The process we use to estimate losses inherent in our loan portfolio requires difficult, subjective and complex judgments, including forecasts of economic conditions and how these economic predictions might impair the ability of our borrowers to repay their loans, which may no longer be capable of accurate estimation and may, in turn, have a negative impact on the reliability of the process.

- The market value and trading volume of our common stock may be subject to increased volatility.

- Our ability to engage in routine funding transactions could be adversely affected by the actions and commercial soundness of other financial institutions and government sponsored entities.

- We may face increased competition due to intensified consolidation of the financial services industry.

If a failure or slowing of the current modest recovery from recessionary conditions occurs, we may experience an adverse effect, which may be material, on our ability to access capital and on our business, financial condition and results of operations.

The value of our investment and MBS securities portfolio may be negatively affected by interest rate changes or disruptions in securities markets and we may realize losses on our investment securities in future periods.

The market for some of the investment securities held in our portfolio experienced extreme volatility over the past two years. Volatile market conditions may detrimentally affect the value of these securities, such as through reduced valuations due to the perception of heightened credit and liquidity risks. Declines in market value associated with these disruptions may result in other-than-temporary or permanent impairments of these assets, which would lead to accounting charges that could have a material adverse effect on our net income, capital levels and liquidity.

In addition, we held $201.1 million of municipal bonds as of December 31, 2010. The current economic downturn has impacted the credit worthiness of a number of municipalities. A continued or further decline in the economy could result in credit ratings downgrades for the municipalities that have issued the bonds held by us, which could negatively impact the value of the bonds.

A decline in the value of our FHLB common stock may occur, resulting in an other-than-temporary impairment charge which would cause our earnings and shareholders equity to decrease.

We own common stock of the FHLB in order to qualify for membership in the FHLB system, which enables us to borrow funds under the FHLB advance program. The carrying value of our FHLB common

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stock was approximately $100 million as of December 31, 2010, the substantial majority of which was with the FHLB of Seattle. The FHLB Seattle has experienced losses from credit-related charges associated with projected losses on its investments in private-label mortgage-backed securities, and is currently unable to repurchase or redeem capital stock or to pay dividends. Consequently, for this and other reasons, there is a risk that our investment in the common stock of the FHLB could be deemed other than temporarily impaired at some time in the future, which would adversely affect our earnings, our shareholders equity and the value of our common stock.

As a bank holding company that conducts substantially all of our operations through our banking subsidiary, Sterling Savings Bank, our ability to pay dividends, repurchase our shares or to repay our indebtedness depends upon liquid assets held by the holding company and the results of operations of our subsidiary.

Sterling is a separate and distinct legal entity from its subsidiaries, and receives substantially all of its revenue from dividends paid by Sterling Savings Bank. There are legal limitations on the extent to which Sterling Savings Bank may extend credit, pay dividends or otherwise supply funds to, or engage in transactions with Sterling. A prolonged inability to receive dividends from Sterling Savings Bank would reduce liquidity available to Sterling, which could adversely affect Sterling s financial condition.

Sterling s net income depends primarily upon Sterling Savings Bank s net interest income, which is the income that remains after deducting from total income generated by earning assets the expense attributable to the acquisition of the funds required to support earning assets (primarily interest paid on deposits). The amount of interest income is dependent on many factors including the volume of earning assets, the general level of interest rates, the dynamics of changes in interest rates and the levels of nonperforming loans. All of those factors affect our banking subsidiary s ability to pay dividends to the holding company.

Various statutory provisions restrict the amount of dividends Sterling Savings Bank can pay to Sterling without regulatory approval. Sterling Savings Bank may not pay cash dividends if those payments could reduce the amount of its capital below that necessary to meet the adequately capitalized level in accordance with regulatory capital requirements. Sterling Savings Bank is also restricted from paying dividends to Sterling pursuant to the terms of the SSB MOU. It is also possible that, depending upon the financial condition of Sterling Savings Bank and other factors, regulatory authorities could assert that payment of dividends or other payments, including payments to us, is an unsafe or unsound practice. Under Washington banking law, Sterling Savings Bank may not pay a dividend greater than its retained earnings without WDFI approval.

We are currently subject to certain pending shareholder litigation and may be subject to similar claims in the future.

A securities class action lawsuit has been filed against Sterling and certain of our current and former officers alleging that the defendants violated sections 10(b) and 20(a) of the U.S. Exchange Act and SEC Rule 10b-5 by making false and misleading statements concerning our business and financial results. A shareholder derivative suit also has been filed against certain of our current and former officers and directors, and Sterling as a nominal defendant, alleging breaches of fiduciary duty, waste of corporate assets, and unjust enrichment. A class action lawsuit is also pending against Sterling, and certain current and former officers and directors of Sterling, alleging violations of ERISA, by breaching their fiduciary duties to participants in the Sterling Savings Bank Employee Savings and Investment Plan and Trust. These lawsuits are all premised on similar allegations that: 1) the defendants failed to adequately disclose the extent of Sterling s delinquent commercial real estate, construction and land development loans, properly record losses for impaired loans, properly reserve for loan losses, and properly account for goodwill and deferred tax assets, thereby causing Sterling s stock price to be artificially inflated during the purported class period; or 2) the defendants failed to prevent Sterling from issuing improper financial statements, maintain a sufficient allowance for loan and lease losses, and establish effective credit risk management and oversight mechanisms. It is possible that additional suits will be filed with respect to these same matters and also naming Sterling and/or its current and former officers and directors.

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These lawsuits could divert the attention and resources of our management and cause us to incur significant expenses for legal fees and costs, including those associated with our advancement of fees and costs on behalf of our current and former officers and directors. We cannot predict the outcome of any of these lawsuits. Since the legal responsibility and financial impact with respect to these lawsuits and claims, if any, cannot currently be ascertained, we have not established any reserves for any potential liability relating to the lawsuits. An unfavorable outcome in any of these lawsuits could result in the payment of substantial damages in connection with a settlement or judgment and have a material adverse effect on our business, financial condition, results of operations or cash flows.

The financial services industry is highly competitive.

We face pricing competition for loans and deposits. We also face competition with respect to customer convenience, product lines, accessibility of service and service capabilities. Our most direct competition comes from other banks, brokerages, mortgage companies and savings institutions. We also face competition from credit unions, government-sponsored enterprises, mutual fund companies, insurance companies and other non-bank businesses. A number of these banks and other financial institutions are significantly larger than we are and have substantially greater access to capital and other resources, as well as larger lending limits and branch systems, and offer a wider array of banking services. Many of our nonbank competitors are not subject to the same extensive regulations that apply to financial institutions. As a result, these non-bank competitors have advantages over us in providing certain services. This significant competition in attracting and retaining deposits and making loans as well as in providing other financial services throughout our market area may have an adverse impact on future earnings and growth.

Our business is highly reliant on technology and our ability to manage the operational risks associated with technology and we are in the process of converting to a new core processing system.

We depend on internal and outsourced technology to support all aspects of our business operations. We expect to convert from the core processing system that is used to manage customer accounts to a processing system offered by another software vendor during the second quarter of 2011. Interruption or failure of these systems creates a risk of business loss as a result of adverse customer experiences, damage claims and civil fines. Risk management programs are expensive to maintain and will not protect us from all risks associated with maintaining the security of customer information, proprietary data, external and internal intrusions, disaster recovery and failures in the controls used by vendors.

Changes in accounting standards may have a material impact on how we report our financial condition and results of operations.

Our accounting policies and methods are fundamental to how we record and report our financial condition and results of operations. From time to time the Financial Accounting Standards Board changes the financial accounting and reporting standards that govern the preparation of our financial statements. These changes can be difficult to predict and can have a material impact on how we record and report our financial condition and results of operations. In some cases, we could be required to apply a new or revised standard retroactively, resulting in a restatement of prior period financial statements.

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

When we sell mortgage loans, whether as whole loans or pursuant to a securitization, we are required to make certain representations and warranties to the purchaser about the mortgage loans and the manner in which they were originated. Our sales agreements on whole loans require us to repurchase or substitute mortgage loans in the event we breach any of these representations or warranties. In addition, we may be required to repurchase mortgage loans as a result of borrower fraud or in the event of early payment default of the borrower on a mortgage loan. Likewise, we are required to repurchase or substitute mortgage loans if we breach a representation or warranty in connection with our securitizations. The

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remedies available to us against the originating broker or correspondent may not be as broad as the remedies available to a purchaser of mortgage loans against us, and we face the further risk that the originating broker or correspondent may not have the financial capacity to perform remedies that otherwise may be available to us. Therefore, if a purchaser enforces its remedies against us, we may not be able to recover our losses from the originating broker or correspondent. If repurchase and indemnity demands increase, our liquidity, results of operations and financial condition will be adversely affected.

Our operations could be interrupted if our third-party service providers experience difficulty, terminate their services or fail to comply with banking regulations.

We depend, and will continue to depend, to a significant extent, on a number of relationships with third-party service providers. Specifically, we receive core systems processing, essential web hosting and other Internet systems and deposit and other transaction processing services from third-party service providers. If these third-party service providers experience difficulties or terminate their services, and we are unable to replace them with other service providers, our operations could be interrupted. If an interruption were to continue for a significant period of time, our business, financial condition and results of operations could be materially adversely affected.

Our internal control systems could fail to detect certain events.

We are subject to certain operations risks, including but not limited to data processing system failures and errors and customer or employee fraud. We maintain a system of internal controls to mitigate against such occurrences and maintain insurance coverage for such risks, but should such an event occur that is not prevented or detected by our internal controls, uninsured or in excess of applicable insurance limits, it could have a significant adverse impact on our business, financial condition or results of operations.

The network and computer systems on which we depend could fail or experience a security breach.

Our computer systems could be vulnerable to unforeseen problems. Because we conduct part of our business over the Internet and outsource several critical functions to third parties, operations will depend on our ability, as well as the ability of third-party service providers, to protect computer systems and network infrastructure against damage from fire, power loss, telecommunications failure, physical break-ins or similar catastrophic events. Any damage or failure that causes interruptions in operations could have a material adverse effect on our business, financial condition and results of operations.

In addition, a significant barrier to online financial transactions is the secure transmission of confidential information over public networks. Our Internet banking system relies on encryption and authentication technology to provide the security and authentication necessary to effect secure transmission of confidential information. Advances in computer capabilities, new discoveries in the field of cryptography or other developments could result in a compromise or breach of the algorithms our third-party service providers use to protect customer transaction data. If any such compromise of security were to occur, it could have a material adverse effect on our business, financial condition and results of operations.

We could be held responsible for environmental liabilities of properties acquired through foreclosure.

If we are forced to foreclose on a defaulted mortgage loan to recover our investment, we may be subject to environmental liabilities related to the underlying real property. Hazardous substances or wastes, contaminants, pollutants or sources thereof may be discovered on properties during our ownership or after a sale to a third party. The amount of environmental liability could exceed the value of real property. We may be fully liable for the entire cost of any removal and clean-up on an acquired property, the cost of removal and clean-up may exceed the value of the property, and we may be unable to recover costs from any third party. In addition, we may find it difficult or impossible to sell the property prior to or following any environmental remediation.

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Item 1B. Unresolved Staff Comments

Not applicable.

Item 2. Properties

Sterling owns the building in which its headquarters are located in Spokane, Washington. As of December 31, 2010, Sterling also owned 101 of its 178 depository banking offices, while leasing the remainder of the properties. These facilities are located throughout Sterling s banking network, primarily in the Pacific Northwest. Additionally, Sterling operates 33 non-depository loan production offices throughout the western United States, the majority of which are leased. See Note 6 of Notes to Consolidated Financial Statements.

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Item 3. Legal Proceedings

Securities Class Action Litigation

On December 11, 2009, a putative securities class action was filed in the United States District Court for the Eastern District of Washington against Sterling and certain of our current and former officers. The Court appointed a lead plaintiff on March 8, 2010. On June 18, 2010, the lead plaintiff filed a consolidated complaint. The complaint alleges that the defendants violated sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 by making false and misleading statements concerning our business and financial results. The complaint alleges that defendants failed to disclose the extent of Sterling s delinquent construction loans, properly record losses for impaired loans, and properly reserve for loan losses. The complaint seeks, on behalf of persons who purchased our common stock during the period from July 23, 2008 to October 15, 2009, damages of an unspecified amount and attorneys fees and costs. On August 30, 2010, Sterling moved to dismiss the complaint. A hearing on the motion to dismiss occurred on March 2, 2011 and an order has not yet been issued. Failure by Sterling to obtain a favorable resolution of the claims set forth in the complaint could have a material adverse effect on our business, results of operations and financial condition. Currently, a loss resulting from these claims is not considered probable or estimable in amount.

ERISA Class Action Litigation

On January 20 and 22, 2010, two putative class action complaints were filed in the United States District Court for the Eastern District of Washington against Sterling Financial Corporation and Sterling Savings Bank (collectively, Sterling), as well as certain of Sterling s current and former officers and directors. The two complaints were merged in a Consolidated Amended Complaint (the Complaint) filed on July 16, 2010 in the same court. The Complaint does not name all of individuals named in the prior complaints, but it is expected that additional defendants will be added. The Complaint alleges that the defendants breached their fiduciary duties under sections 404 and 405 of ERISA, with respect to the Sterling Savings Bank Employee Savings and Investment Plan (the 401(k) Plan) and the FirstBank Northwest Employee Stock Ownership Plan (ESOP) (collectively, the Plans). Specifically, the Complaint alleges that the defendants breached their duties by investing assets of the Plans in Sterling s securities when it was imprudent to do so, and by investing such assets in Sterling securities when defendants knew or should have known that the price of those securities was inflated due to misrepresentations and omissions about Sterling s business practices. The business practices at issue include alleged over-reliance on risky construction loans; alleged inadequate loan reserves; alleged spiking increases in nonperforming assets, nonperforming loans, classified assets, and 90+-day delinquent loans; alleged inadequate accounting for rising loan payment shortfalls; alleged unsafe and unsound banking practices; and a capital base that was allegedly inadequate to withstand the significant deterioration in the real estate markets. The putative class periods are October 22, 2007 to the present for the 401(k) Plan class, and October 22, 2007 to November 14, 2008 for the ESOP class. The Complaint seeks damages of an unspecified amount and attorneys fees and costs. A hearing on the motion to dismiss is currently scheduled for March 22, 2011. Failure by Sterling to obtain a favorable resolution of the claims set forth in the Complaint could have a material adverse effect on Sterling s business, results of operations, and financial condition. Currently, a loss resulting from these claims is not considered probable or estimable in amount.

Derivative Class Action Litigation

On February 10, 2010, a shareholder derivative action was filed in the Superior Court for Spokane County, Washington, allegedly on behalf of and for the benefit of Sterling, against certain of our current and former officers and directors. On August 2, 2010, an amended complaint was filed alleging, among other claims, breach of fiduciary duty, waste of corporate assets, and unjust enrichment. The amended complaint names Sterling as a nominal defendant. The complaint seeks unspecified damages, restitution, disgorgement of profits, equitable and injunctive relief, attorneys fees, costs, and expenses. The complaint alleges that the individual defendants failed to prevent Sterling from issuing improper financial statements,

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maintain a sufficient allowance for loan and lease losses, and establish effective credit risk management and oversight mechanisms regarding Sterling s construction loans, losses and reserves recorded for impaired loans, and accounting for goodwill and deferred tax assets. On September 13, 2010, Sterling moved to dismiss the complaint. A hearing on the motion to dismiss occurred on January 14, 2011, with the court indicating that it would deny the motion. An order has not yet been issued. Because the complaint is derivative in nature, it does not seek monetary damages from Sterling. However, Sterling may be required throughout the pendency of the action to advance the legal fees and costs incurred by the individual defendants and to incur other financial obligations, which could have a material adverse effect on our business, results of operations and financial condition. Currently, a loss resulting from these claims is not considered probable or estimable in amount.

Item 4. (Reserved)

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PART II

Item 5. Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Stock Market and Dividend Information

Sterling s common stock is listed on the NASDAQ Capital Market under the symbol STSA. As of January 31, 2011, Sterling s common stock was held by 1,347 shareholders of record. On November 18, 2010, Sterling effected a 1-for-66 reverse stock split, as reflected at the open of trading on the following day. All prior per share amounts have been restated to reflect this split. The following table sets forth certain per share information for Sterling s common stock for the periods indicated:

	2010 Quarters Ended			
	December 31	September 30	June 30	March 31
Dividends declared per common share	$ 0.00	$ 0.00	$ 0.00	$ 0.00
Dividends paid per common share	0.00	0.00	0.00	0.00
Market price per share:				
High	46.20	49.50	133.99	61.39
Low	14.85	32.34	30.36	28.38
Quarter end	18.97	42.90	36.30	37.62

	2009 Quarters Ended			
	December 31	September 30	June 30	March 31
Dividends declared per common share	$ 0.00	$ 0.00	$ 0.00	$ 0.00
Dividends paid per common share	0.00	0.00	0.00	0.00
Market price per share:				
High	132.01	236.96	339.93	605.94
Low	32.35	126.07	132.01	66.01
Quarter end	40.92	132.01	192.08	136.63

The board of directors of Sterling from time to time evaluates the payment of cash dividends. The timing and amount of any future dividends will depend upon earnings, cash and capital requirements, the financial condition of Sterling and its subsidiaries, applicable government regulations and other factors deemed relevant by Sterling s board of directors. Currently, Sterling is not to pay cash dividends or make any other payments or distributions representing a reduction of Sterling Savings Bank capital without the prior written consent from its regulators. During the third quarter of 2009, Sterling elected to defer regularly scheduled interest payments on its junior subordinated debentures. Sterling is allowed to defer payments of interest on the junior subordinated debentures for up to 20 consecutive quarterly periods without triggering an event of default. As of December 31, 2010 and 2009, the accrued deferred interest was $9.4 million and $3.4 million, respectively. Sterling is precluded from paying dividends on its common stock without first paying the accrued interest on these junior subordinated debentures. Pursuant to the terms of the Treasury Exchange, subject to certain exceptions, Sterling will be unable to pay cash dividends on its common stock without the Treasury s consent until the earlier of December 5, 2011, or such time as the Treasury ceases to own any debt or equity securities acquired pursuant to the Exchange Agreement or the Treasury Warrant.

Information concerning securities authorized for issuance under equity compensation plans is set forth under the caption Equity Compensation Plan Information in Sterling s Proxy Statement and is incorporated herein by reference.

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Performance Graph

The following graph, which is furnished, not filed, compares the cumulative return of our common stock during the five years ended December 31, 2010, with the Russell 2000 Index and the SNL Bank NASDAQ Index. The presentation assumes an initial investment of $100 and the reinvestment of dividends.

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Item 6. Selected Financial Data

The following selected financial data is derived from Sterling s audited financial statements. Comparability among particular amounts may be affected by past acquisitions:

	Years Ended December 31,				
	2010	2009	2008	2007	2006
	(Dollars in thousands, except per share amounts)				
Income Statement Data:					
Interest income	$ 445,133	$ 599,347	$ 715,062	$ 766,978	$ 550,855
Interest expense	161,106	255,370	355,510	411,618	286,943
Net interest income	284,027	343,977	359,552	355,360	263,912
Provision for credit losses	250,229	681,371	333,597	25,088	18,703
Net interest income after provision for credit losses	33,798	(337,394)	25,955	330,272	245,209
Noninterest income	136,965	123,814	91,895	93,406	69,164
Noninterest expense	395,045	369,974	305,517	285,465	206,197
Goodwill impairment	0	227,558	223,765	0	0
Total noninterest expense	395,045	597,532	529,282	285,465	206,197
(Loss) income before income taxes	(224,282)	(811,112)	(411,432)	138,213	108,176
Income tax (provision) benefit	0	(26,982)	75,898	(44,924)	(34,230)
Net (loss) income	(224,282)	(838,094)	(335,534)	93,289	73,946
Preferred stock dividend	(11,598)	(17,369)	(1,208)	0	0
Other shareholder allocations [(1)]	(520,263)	0	0	0	0
Net (loss) income applicable to common shareholders	$ (756,143)	$ (855,463)	$ (336,742)	$ 93,289	$ 73,946
(Loss) earnings per common share:					
Basic [(2)]	$ (53.05)	$ (1,087.41)	$ (429.70)	$ 123.67	$ 133.99
Diluted [(2)]	(53.05)	(1,087.41)	(429.70)	122.61	132.47
Dividends declared per common share [(2)]	$ 0.00	$ 0.00	$ 19.80	$ 23.10	$ 17.82
Weighted average shares outstanding:					
Basic [(2)]	14,253,869	786,701	783,662	754,339	551,865
Diluted [(2)]	14,253,869	786,701	783,662	760,871	558,210
Other Data:					
Book value per common share [(2)]	$ 12.45	$ 36.80	$ 1,075.14	$ 1,520.64	$ 1,229.58
Tangible book value per common share [(2)]	$ 12.17	$ 9.21	$ 752.98	$ 898.26	$ 796.62
Return on average assets	-2.21%	-6.81%	-2.65%	0.83%	0.88%
Return on average common equity	-297.2%	-129.8%	-28.8%	8.6%	13.0%
Dividend payout ratio	0%	0%	-5%	19%	13%
Shareholders equity to total assets	8.1%	3.0%	8.9%	9.8%	8.0%
Tangible common equity to tangible assets	8.0%	0.1%	4.7%	6.0%	5.3%
Operating efficiency	93.8%	127.7%	117.2%	63.6%	61.9%

Tax equivalent net interest margin	2.83%	2.92%	3.08%	3.42%	3.33%
Nonperforming assets to total assets	8.83%	9.08%	4.77%	1.11%	0.13%
Employees (full-time equivalents)	2,498	2,641	2,481	2,571	2,405
Depository branches	178	178	178	178	166

(1) The August 26, 2010 conversion of Series C preferred stock into common stock resulted in an increase in income available to common shareholders. The October 22, 2010 conversion of Series B and D preferred stock into common stock resulted in a decrease in income available to common shareholders.

(2) Reflects the 1-for-66 reverse stock split in November 2010.

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Item 6. Selected Financial Data (continued)

	December 31,				
	2010	**2009**	**2008**	**2007**	**2006**
	(Dollars in thousands)				
Balance Sheet Data:					
Total assets	$ 9,493,169	$ 10,877,423	$ 12,790,716	$ 12,149,775	$ 9,834,492
Loans receivable, net	5,379,081	7,344,199	8,807,094	8,948,307	7,021,241
Investments and MBS available for sale	2,825,010	2,160,325	2,639,290	1,853,271	1,728,686
Investments held to maturity	13,464	17,646	175,830	132,793	93,063
Deposits	6,911,007	7,775,190	8,350,407	7,677,772	6,746,028
FHLB advances	407,211	1,337,167	1,726,549	1,687,989	1,308,617
Reverse repurchase agreements and funds purchased	1,032,512	1,049,146	1,163,023	1,178,845	616,354
Other borrowings	245,285	248,281	248,276	273,015	240,226
Shareholders equity	770,767	323,249	1,141,036	1,185,330	783,416
Regulatory Capital Ratios:					
Tier 1 leverage ratio:					
Sterling	10.1%	3.5%	9.2%	8.7%	8.7%
Sterling Savings Bank	9.8%	4.2%	8.3%	8.5%	8.6%
Tier 1 risk-based capital ratio:					
Sterling	16.2%	4.9%	11.7%	10.1%	10.0%
Sterling Savings Bank	15.7%	5.9%	10.6%	9.8%	9.7%
Total risk-based capital ratio:					
Sterling	17.5%	7.9%	13.0%	11.3%	11.1%
Sterling Savings Bank					