

STERLING FINANCIAL CORP /WA/
Form 10-Q
November 06, 2012
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended SEPTEMBER 30, 2012

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 (I.R.S. Employer
incorporation or organization) Identification No.)
111 North Wall Street, Spokane, Washington 99201
(Address of principal executive offices) (Zip Code)
(509) 358-8097
(Registrant’s telephone number, including area code)

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

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

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

Large accelerated filer Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company) 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

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

| | |
|--------------|------------------------------------|
| Class | Outstanding as of October 31, 2012 |
| Common Stock | 62,148,022 |

Table of Contents

TABLE OF CONTENTS

September 30, 2012

| | Page |
|---|------------|
| PART I - Financial Information | |
| Item 1 Financial Statements (Unaudited) | |
| <u>Consolidated Balance Sheets</u> | <u>3</u> |
| <u>Consolidated Statements of Income</u> | <u>4</u> |
| <u>Consolidated Statements of Comprehensive Income</u> | <u>5</u> |
| <u>Consolidated Statements of Cash Flows</u> | <u>6</u> |
| <u>Notes to Consolidated Financial Statements</u> | <u>8</u> |
| Item 2 <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | <u>36</u> |
| Item 3 <u>Quantitative and Qualitative Disclosures About Market Risk</u> | <u>52</u> |
| Item 4 <u>Controls and Procedures</u> | <u>52</u> |
| PART II - Other Information | <u>53</u> |
| Item 1 <u>Legal Proceedings</u> | <u>53</u> |
| Item 1A <u>Risk Factors</u> | <u>54</u> |
| Item 2 <u>Unregistered Sales of Equity Securities and Use of Proceeds</u> | <u>54</u> |
| Item 3 <u>Defaults Upon Senior Securities</u> | <u>54</u> |
| Item 4 <u>Mine Safety Disclosures</u> | <u>54</u> |
| Item 5 <u>Other Information</u> | <u>54</u> |
| Item 6 <u>Exhibits</u> | <u>54</u> |
| <u>Signature</u> | <u>55</u> |
| <u>Exhibit Index</u> | <u>E-1</u> |

Table of Contents

STERLING FINANCIAL CORPORATION
CONSOLIDATED BALANCE SHEETS (UNAUDITED)
(in thousands, except shares)

| | September 30, 2012 | December 31, 2011 |
|---|-----------------------|----------------------|
| ASSETS: | | |
| Cash and cash equivalents: | | |
| Interest bearing | \$ 145,522 | \$ 382,330 |
| Noninterest bearing | 86,691 | 88,269 |
| Total cash and cash equivalents | 232,213 | 470,599 |
| Restricted cash | 31,671 | 20,629 |
| Investments and mortgage-backed securities ("MBS"): | | |
| Available for sale | 2,049,961 | 2,547,876 |
| Held to maturity | 1,716 | 1,747 |
| Loans held for sale (at fair value: \$320,823 and \$223,638) | 320,823 | 273,957 |
| Loans receivable, net | 5,990,365 | 5,341,179 |
| Accrued interest receivable | 32,031 | 32,826 |
| Other real estate owned, net ("OREO") | 46,575 | 81,910 |
| Properties and equipment, net | 92,987 | 84,015 |
| Bank-owned life insurance ("BOLI") | 178,279 | 174,512 |
| Goodwill | 22,577 | 0 |
| Other intangible assets, net | 20,864 | 12,078 |
| Mortgage servicing rights, net | 26,819 | 23,102 |
| Deferred tax asset, net | 280,373 | 0 |
| Other assets, net | 145,183 | 128,807 |
| Total assets | \$9,472,437 | \$9,193,237 |
| LIABILITIES: | | |
| Deposits: | | |
| Noninterest bearing | \$ 1,709,612 | \$ 1,211,628 |
| Interest bearing | 5,030,298 | 5,274,190 |
| Total deposits | 6,739,910 | 6,485,818 |
| Advances from Federal Home Loan Bank ("FHLB") | 155,401 | 405,609 |
| Securities sold under repurchase agreements and funds purchased | 942,547 | 1,055,763 |
| Junior subordinated debentures | 245,293 | 245,290 |
| Accrued interest payable | 6,592 | 22,575 |
| Accrued expenses and other liabilities | 131,207 | 99,625 |
| Total liabilities | 8,220,950 | 8,314,680 |
| SHAREHOLDERS' EQUITY: | | |
| Preferred stock, 10,000,000 shares authorized; no shares outstanding | 0 | 0 |
| Common stock, 151,515,151 shares authorized; 62,150,650 and 62,057,645 shares outstanding, respectively | 1,967,562 | 1,964,234 |
| Accumulated other comprehensive income | 75,263 | 61,115 |
| Accumulated deficit | (791,338) | (1,146,792) |
| Total shareholders' equity | 1,251,487 | 878,557 |
| Total liabilities and shareholders' equity | \$9,472,437 | \$9,193,237 |

See notes to consolidated financial statements.

Table of Contents

STERLING FINANCIAL CORPORATION
CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)
(in thousands, except share amounts)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|------------|------------------------------------|------------|
| | 2012 | 2011 | 2012 | 2011 |
| Interest income: | | | | |
| Loans | \$83,110 | \$82,010 | \$248,488 | \$242,132 |
| MBS | 10,361 | 16,719 | 38,632 | 56,681 |
| Investments and cash equivalents | 2,520 | 2,650 | 7,826 | 8,150 |
| Total interest income | 95,991 | 101,379 | 294,946 | 306,963 |
| Interest expense: | | | | |
| Deposits | 8,981 | 14,135 | 30,004 | 46,645 |
| Short-term borrowings | 2,346 | 657 | 6,377 | 847 |
| Long-term borrowings | 9,356 | 11,751 | 29,994 | 36,085 |
| Total interest expense | 20,683 | 26,543 | 66,375 | 83,577 |
| Net interest income | 75,308 | 74,836 | 228,571 | 223,386 |
| Provision for credit losses | 2,000 | 6,000 | 10,000 | 26,000 |
| Net interest income after provision for credit losses | 73,308 | 68,836 | 218,571 | 197,386 |
| Noninterest income: | | | | |
| Fees and service charges | 14,675 | 12,332 | 41,546 | 37,839 |
| Mortgage banking operations | 28,502 | 16,360 | 69,318 | 37,481 |
| Loan servicing fees | (2,092) | (4,694) | (183) | (2,884) |
| BOLI | 1,660 | 1,612 | 7,175 | 4,922 |
| Gains on sales of securities | 3,129 | 0 | 12,592 | 14,298 |
| Other-than-temporary impairment credit losses on securities (1) | 0 | 0 | (6,819) | 0 |
| Charge on prepayment of debt | 0 | 0 | (2,664) | 0 |
| Gains on other loan sales | 476 | 2,671 | 3,887 | 1,792 |
| Other | 348 | 831 | (1,826) | (19) |
| Total noninterest income | 46,698 | 29,112 | 123,026 | 93,429 |
| Noninterest expense | 89,408 | 86,620 | 265,664 | 266,515 |
| Income before income taxes | 30,598 | 11,328 | 75,933 | 24,300 |
| Income tax benefit | 0 | 0 | 288,842 | 0 |
| Net income | \$30,598 | \$11,328 | \$364,775 | \$24,300 |
| Earnings per share - basic | \$0.49 | \$0.18 | \$5.87 | \$0.39 |
| Earnings per share - diluted | \$0.49 | \$0.18 | \$5.81 | \$0.39 |
| Dividends declared per share | \$0.15 | \$0.00 | \$0.15 | \$0.00 |
| Weighted average shares outstanding - basic | 62,139,833 | 61,958,183 | 62,110,498 | 61,944,392 |
| Weighted average shares outstanding - diluted | 62,845,864 | 62,041,203 | 62,745,177 | 62,236,465 |

(1) The other-than-temporary impairment recognized in earnings during the second quarter of 2012 did not have a portion recognized in accumulated other comprehensive income. See Note 3.

See notes to consolidated financial statements.

Table of Contents

STERLING FINANCIAL CORPORATION
 CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)
 (in thousands)

| | Three Months Ended | | Nine Months Ended | |
|--|--------------------|----------|-------------------|-----------|
| | September 30, | | September 30, | |
| | 2012 | 2011 | 2012 | 2011 |
| Net income | \$30,598 | \$11,328 | \$364,775 | \$24,300 |
| Other comprehensive income: | | | | |
| Change in unrealized gains on investments and MBS available for sale | 16,235 | 39,564 | 28,547 | 78,158 |
| Realized net gains reclassified from other comprehensive income | (3,129 |) 0 | (5,773 |) (14,298 |
| Less deferred income tax provision | (4,945 |) 0 | (8,626 |) (2,384 |
| Net other comprehensive income | 8,161 | 39,564 | 14,148 | 61,476 |
| Comprehensive income | \$38,759 | \$50,892 | \$378,923 | \$85,776 |

See notes to consolidated financial statements.

5

Table of Contents

STERLING FINANCIAL CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)
(in thousands)

| | Nine Months Ended September 30, | |
|---|------------------------------------|-------------|
| | 2012 | 2011 |
| Cash flows from operating activities: | | |
| Net income | \$364,775 | \$24,300 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for credit losses | 10,000 | 26,000 |
| Net gain on sales of loans | (71,482) | (33,754) |
| Net gain on sales of investments and MBS | (12,592) | (14,298) |
| Net loss (gain) on mortgage servicing rights | 984 | (4,253) |
| Other-than-temporary impairment credit losses on securities | 6,819 | 0 |
| Stock based compensation | 2,756 | 2,949 |
| Loss on OREO | 32 | 17,380 |
| Release of DTA valuation allowance | (288,842) | 0 |
| Increase in cash surrender value of BOLI | (6,924) | (4,804) |
| Depreciation and amortization | 33,871 | 30,161 |
| Change in: | | |
| Accrued interest receivable | 4,325 | 469 |
| Prepaid expenses and other assets | (23,295) | 4,246 |
| Accrued interest payable | (16,116) | 3,893 |
| Accrued expenses and other liabilities | 19,606 | (1,279) |
| Proceeds from sales of loans originated for sale | 1,937,131 | 1,394,273 |
| Loans originated for sale | (2,010,310) | (1,399,822) |
| Net cash (used in) provided by operating activities | (49,262) | 45,461 |
| Cash flows from investing activities: | | |
| Change in restricted cash | (11,042) | (3,514) |
| Net change in loans | (317,773) | (254,078) |
| Proceeds from sales of loans | 75,689 | 39,320 |
| Purchase of investment securities | (3,734) | (9,857) |
| Proceeds from maturities of investment securities | 18,939 | 478 |
| Proceeds from sale of investment securities | 179,235 | 30,987 |
| Purchase of MBS | (287,849) | (264,156) |
| Principal payments received on MBS | 467,792 | 341,827 |
| Proceeds from sales of MBS | 326,915 | 353,444 |
| Proceeds from BOLI death benefits | 3,714 | 0 |
| Office properties and equipment, net | (14,144) | (13,069) |
| Improvements and other changes to OREO | (1,214) | (5,357) |
| Proceeds from sales of OREO | 67,200 | 197,528 |
| Net change in cash and cash equivalents from acquisitions | 121,098 | 0 |
| Net cash provided by investing activities | \$624,826 | \$413,553 |

See notes to consolidated financial statements.

Table of Contents

STERLING FINANCIAL CORPORATION
 CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)—cont.
 (in thousands)

| | Nine Months Ended September 30, | |
|---|------------------------------------|----------------|
| | 2012 | 2011 |
| Cash flows from financing activities: | | |
| Net change in deposits | \$(441,827 |) \$(431,767) |
| Advances from FHLB | 50,000 | 0 |
| Repayment of advances from FHLB | (300,157 |) (148) |
| Net change in securities sold under repurchase agreements and funds purchased | (113,216 |) 23,840 |
| Proceeds from stock issuance, net | 572 | 0 |
| Cash dividend paid | (9,322 |) 0 |
| Net cash used in financing activities | (813,950 |) (408,075) |
| Net change in cash and cash equivalents | (238,386 |) 50,939 |
| Cash and cash equivalents, beginning of period | 470,599 | 411,583 |
| Cash and cash equivalents, end of period | \$232,213 | \$462,522 |
| Supplemental disclosures: | | |
| Cash paid during the period for: | | |
| Interest | \$82,358 | \$79,684 |
| Income taxes, net | 81 | 0 |
| Noncash financing and investing activities: | | |
| Foreclosed real estate acquired in settlement of loans | 30,683 | 159,464 |

See notes to consolidated financial statements.

7

Table of Contents

STERLING FINANCIAL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2012

1. Basis of Presentation:

The foregoing unaudited interim consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X as promulgated by the Securities and Exchange Commission. Accordingly, these financial statements do not include all of the disclosures required by accounting principles generally accepted in the United States of America for complete financial statements. These unaudited interim consolidated financial statements should be read in conjunction with the audited consolidated financial statements as disclosed in the annual report on Form 10-K for the year ended December 31, 2011. References to "Sterling," in this report are 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 Bank" refer to our subsidiary Sterling Savings Bank, a Washington state-chartered commercial bank. In the opinion of management, the unaudited interim consolidated financial statements furnished herein include all adjustments, all of which are of a normal recurring nature, necessary for a fair statement of the results for the interim periods presented.

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

During 2012, Sterling identified an error related to the classification of the loss on foreclosure amounts reported in the Consolidated Statement of Cash Flows for the quarter ended March 31, 2012, and for the years ended December 31, 2011 and 2010, and the interim periods therein. The loss on foreclosure amounts were previously included in the cash flows from operating activities in the Loss on OREO line item, instead of the cash flows from investing activities in the Net change in loans line item. In accordance with the SEC Staff Accounting Bulletin (SAB) No. 99, "Materiality," and SAB No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements," management evaluated the materiality of the error from qualitative and quantitative perspectives and concluded that the error was immaterial to prior periods. Consequently, the Consolidated Statement of Cash Flows contained in this Report has been revised for the nine months ended September 30, 2011. This change resulted in a decrease of \$44.2 million to cash flows from operating activities and an increase of the same amount to cash flows from investing activities for the nine months ended September 30, 2011. This change did not affect net income, the balance sheet, or shareholders' equity for any period.

In addition to other established accounting policies, the following is a discussion of recent accounting pronouncements:

In April 2011, the FASB issued Accounting Standards Update ("ASU") 2011-03, "Reconsideration of Effective Control for Repurchase Agreements." This update to codification topic 860 revises the assessment of effective control for purposes of determining if a reverse repurchase agreement should be accounted for as a sale, compared with a secured borrowing. ASU 2011-03 became effective for Sterling on January 1, 2012, and did not have a material effect on Sterling's consolidated financial statements.

In May 2011, the FASB issued ASU 2011-04, "Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS." This update to codification topic 820 clarifies the application of existing fair value measurement and disclosure requirements, and implements changes to the codification that align U.S. GAAP and IFRS. This update became effective for Sterling on January 1, 2012, and did not have a material effect on Sterling's consolidated financial statements.

In December 2011, the FASB issued ASU 2011-11, "Balance Sheet: Disclosures about Offsetting Assets and Liabilities." ASU 2011-11 adds certain additional disclosure requirements about financial instruments and derivatives instruments that are subject to netting arrangements. The new disclosures are required for annual reporting periods beginning on or after January 1, 2013, and interim periods within those periods. This standard could add additional disclosures if applicable to Sterling. However, it is not expected to have a material impact on Sterling's consolidated financial statements.

Table of Contents

In September 2011, the FASB issued ASU 2011-08, "Intangibles-Goodwill and Other: Testing Goodwill for Impairment." ASU 2011-08 is intended to simplify goodwill impairment testing by adding a qualitative review step to assess whether the required quantitative impairment analysis that exists today is necessary. Under the amended rule, a company will not be required to calculate the fair value of a business that contains recorded goodwill unless it concludes, based on the qualitative assessment, that it is more likely than not that the fair value of that business is less than its book value. If such a decline in fair value is deemed more likely than not to have occurred, then the quantitative goodwill impairment test that exists under current GAAP must be completed; otherwise, goodwill is deemed to be not impaired and no further testing is required until the next annual test date (or sooner if conditions or events before that date raise concerns of potential impairment in the business). The amended goodwill impairment guidance does not affect the manner in which a company estimates fair value. ASU 2011-08 became effective for Sterling on January 1, 2012, and did not have a material effect on Sterling's consolidated financial statements.

2. Business Combination:

On February 29, 2012, Sterling Bank completed its acquisition of the operations of First Independent Bank ("First Independent"), by acquiring certain assets and assuming certain liabilities, including all deposits for a net purchase price of \$40.6 million, comprised of \$28.9 million of cash paid at closing and contingent consideration with a fair value of \$11.7 million at acquisition date. As of September 30, 2012 and because of favorable performance, the fair value of this contingent consideration was estimated at \$14.1 million, with the increase reflected as a charge against earnings. The contingent consideration is payable in two installments at 12 and 18 months from the date of closing, in an amount ranging from zero to \$17 million. The contingent consideration payments will be determined based on certain performance metrics relating to core deposit retention, loan charge-offs, and wealth management revenues. As a result of this transaction, Sterling now offers trust services, and has 14 additional branches in the Portland/Vancouver market. The following table summarizes the amounts recorded at closing:

| | February 29, 2012 (in thousands) |
|---------------------------|-------------------------------------|
| Cash and cash equivalents | \$150,045 |
| Investments and MBS | 187,465 |
| Loans receivable, net | 349,990 |
| Goodwill | 22,577 |
| Core deposit intangible | 11,974 |
| Fixed assets | 4,038 |
| Other assets | 10,886 |
| Total assets acquired | \$736,975 |
| Deposits | \$695,919 |
| Other liabilities | 409 |
| Total liabilities assumed | 696,328 |
| Net assets acquired | \$40,647 |

The recorded goodwill of \$22.6 million represents the inherent long-term value anticipated from synergies expected to be achieved as a result of the transaction. The amount recorded for goodwill includes subsequent adjustments, primarily from updated appraisals on fixed assets. The amount of goodwill deductible for income tax purposes is approximately equivalent to the recorded book value. The core deposit intangible has a weighted average amortization period of ten years and will be amortized on an accelerated basis. The following table presents certain First Independent stand alone amounts and pro forma Sterling and First Independent combined amounts as if the transaction had occurred on January 1, 2011. Cost savings estimates are not included in the pro forma combined results, nor are certain credit impaired loans and associated losses excluded from the purchase and assumption transaction.

Table of Contents

| | First Independent (stand alone) | | Pro Forma Combined | | Pro Forma Combined | |
|------------------------------|---------------------------------------|-------------------|--------------------|--------------------|--------------------|--------------------|
| | Three Months Ended | Nine Months Ended | Three Months Ended | September 30, 2011 | September 30, 2012 | September 30, 2011 |
| | September 30, 2012 | | September 30, 2012 | September 30, 2011 | September 30, 2012 | September 30, 2011 |
| | (in thousands, except per share data) | | | | | |
| Net interest income | \$5,104 | \$16,204 | \$75,308 | \$82,639 | \$235,052 | \$247,355 |
| Noninterest income | 1,247 | 3,428 | 46,698 | 31,662 | 124,031 | 100,693 |
| Net income | 2,630 | 8,638 | 30,598 | 13,556 | 368,989 | 33,962 |
| Earnings per share - basic | 0.04 | 0.14 | 0.49 | 0.22 | 5.94 | 0.55 |
| Earnings per share - diluted | \$0.04 | \$0.14 | \$0.49 | \$0.22 | \$5.89 | \$0.55 |

Although the majority of First Independent's credit impaired loans were excluded from the transaction, certain loans acquired were deemed to exhibit evidence of credit deterioration since origination and therefore, were classified as impaired. The accounting for purchased impaired loans is periodically updated for changes in the loans' cash flow expectations, and reflected in interest income over the life of the loans as accretable yield. For purchased impaired loans, details as of the acquisition date were as follows:

| | February 29, 2012 (in thousands) |
|--|-------------------------------------|
| Contractual cash flows | \$24,408 |
| Expected prepayments and credit losses | 7,220 |
| Expected cash flows | 17,188 |
| Present value of expected cash flows | 15,265 |
| Accretable yield | \$1,923 |

As of September 30, 2012, no allowance for credit losses was recorded in connection with these loans, and the unpaid principal balance and carrying amount of the purchased impaired loans were \$18.4 million and \$11.3 million, respectively. The following table presents a roll-forward of activity for the accretable yield for the purchased impaired loans:

| | Three Months Ended September 30, 2012 (in thousands) | Nine Months Ended |
|------------------------------|--|-------------------|
| Beginning balance | \$2,331 | \$0 |
| Additions | 0 | 1,923 |
| Accretion to interest income | (223 |) (545 |
| Reclassifications | (678 |) 52 |
| Ending balance | \$1,430 | \$1,430 |

Table of Contents

As of February 29, 2012, the unpaid principal balance and contractual interest ("contractual cash flows") on purchased loans that had not exhibited evidence of credit deterioration was \$403.8 million. Sterling estimated that \$12.7 million of these cash flows would be uncollectable, resulting in a discount of \$21.8 million being recorded on these loans. The following table presents the related five-year projected accretion of the discount which will be recognized as an increase to interest income as of September 30, 2012:

| | Amount |
|--------------------------|--------|
| Remainder of 2012 | 1,600 |
| Years ended December 31, | |
| 2013 | 4,210 |
| 2014 | 2,796 |
| 2015 | 1,724 |
| 2016 | 1,031 |
| 2017 | 679 |

3. Investments and MBS:

The carrying and fair values of investments and MBS are summarized as follows:

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|--------------------|-------------------|------------------------------|-------------------------------|---------------|
| | (in thousands) | | | |
| September 30, 2012 | | | | |
| Available for sale | | | | |
| MBS | \$1,757,584 | \$67,864 | \$0 | \$1,825,448 |
| Municipal bonds | 188,579 | 17,354 | (528) |) 205,405 |
| Other | 18,251 | 857 | 0 | 19,108 |
| Total | \$1,964,414 | \$86,075 | \$(528) |) \$2,049,961 |
| Held to maturity | | | | |
| Tax credits | \$1,716 | \$0 | \$0 | \$1,716 |
| Total | \$1,716 | \$0 | \$0 | \$1,716 |
| December 31, 2011 | | | | |
| Available for sale | | | | |
| MBS | \$2,265,207 | \$55,760 | \$(33) |) \$2,320,934 |
| Municipal bonds | 195,512 | 13,338 | (1,394) |) 207,456 |
| Other | 24,923 | 2 | (5,439) |) 19,486 |
| Total | \$2,485,642 | \$69,100 | \$(6,866) |) \$2,547,876 |
| Held to maturity | | | | |
| Tax credits | \$1,747 | \$0 | \$0 | \$1,747 |
| Total | \$1,747 | \$0 | \$0 | \$1,747 |

Sterling's MBS portfolio is comprised primarily of residential agency securities. Other available for sale securities consist of a single issuer trust preferred security.

Table of Contents

Total sales of Sterling's securities during the periods ended September 30, 2012 and 2011 are summarized as follows:

| | Proceeds from Sales (in thousands) | Gross Realized Gains | Gross Realized Losses |
|--------------------|--|-------------------------|--------------------------|
| Nine Months Ended | | | |
| September 30, 2012 | \$506,150 | \$12,666 | \$(74) |
| September 30, 2011 | 384,431 | 16,605 | (2,307) |

The following table summarizes Sterling's investments and MBS that had a market value below their amortized cost as of September 30, 2012 and December 31, 2011, segregated by those investments that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 months or longer:

| | Less than 12 months | | 12 months or longer | | Total | Unrealized |
|--------------------|-----------------------------------|----------------------|---------------------|----------------------|-----------------|------------|
| | Market Value (in thousands) | Unrealized Losses | Market Value | Unrealized Losses | Market Value | Losses |
| September 30, 2012 | | | | | | |
| MBS | \$0 | \$0 | \$0 | \$0 | \$0 | \$0 |
| Municipal bonds | 0 | 0 | 12,664 | (528) | 12,664 | (528) |
| Other | 0 | 0 | 0 | 0 | 0 | 0 |
| Total | \$0 | \$0 | \$12,664 | \$(528) | \$12,664 | \$(528) |
| December 31, 2011 | | | | | | |
| MBS | \$1,419 | \$(12) | \$24,726 | \$(21) | \$26,145 | \$(33) |
| Municipal bonds | 0 | 0 | 17,289 | (1,394) | 17,289 | (1,394) |
| Other | 0 | 0 | 19,479 | (5,439) | 19,479 | (5,439) |
| Total | \$1,419 | \$(12) | \$61,494 | \$(6,854) | \$62,913 | \$(6,866) |

The following table presents the amortized cost and fair value of available for sale and held to maturity securities as of September 30, 2012, grouped by contractual maturity. Actual maturities for MBS will differ from contractual maturities as a result of the level of prepayments experienced on the underlying mortgages.

| | Held to maturity | | Available for sale | |
|--|------------------|-------------------------|--------------------|-------------------------|
| | Amortized Cost | Estimated Fair Value | Amortized Cost | Estimated Fair Value |
| | (in thousands) | | | |
| Due within one year | \$0 | \$0 | \$0 | \$0 |
| Due after one year through five years | 0 | 0 | 0 | 0 |
| Due after five years through ten years | 0 | 0 | 134,019 | 138,991 |
| Due after ten years | 1,716 | 1,716 | 1,830,395 | 1,910,970 |
| Total | \$1,716 | \$1,716 | \$1,964,414 | \$2,049,961 |

Management evaluates investment securities for other-than-temporary declines in fair value each quarter. If the fair value of investment securities falls below the amortized cost and the decline is deemed to be other-than-temporary, the securities are written down to current market value, resulting in the recognition of an other-than-temporary impairment ("OTTI"). As of September 30, 2012, Sterling held a single issuer trust preferred security issued by JP Morgan Chase with a par value of \$27.5 million, and a fair value of \$19.1 million. During the second quarter of 2012, Sterling recognized an OTTI charge on the security of \$6.8 million, resulting in a new amortized cost basis of \$18.2 million. The security is rated Baa2 by Moody's. Interest payments have not been deferred. Sterling intends to sell the

security prior to its scheduled maturity or recovery of its amortized cost basis.

12

Table of Contents

The following table presents a roll-forward of OTTI for the periods presented:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|-------------------------|----------------------------------|------|---------------------------------|------|
| | 2012 | 2011 | 2012 | 2011 |
| | (in thousands) | | | |
| OTTI, beginning balance | \$6,819 | \$0 | \$0 | \$0 |
| Additions | 0 | 0 | 6,819 | 0 |
| Ending Balance | \$6,819 | \$0 | \$6,819 | \$0 |

4. Loans Receivable and Allowance for Credit Losses:

The following table presents the composition of Sterling's loan portfolio as of the balance sheet dates:

| | September 30, | December 31, |
|---------------------------------|----------------|--------------|
| | 2012 | 2011 |
| | (in thousands) | |
| Residential real estate | \$818,323 | \$688,020 |
| Commercial real estate ("CRE"): | | |
| Investor CRE | 1,274,774 | 1,275,667 |
| Multifamily | 1,359,506 | 1,001,479 |
| Construction | 99,553 | 174,608 |
| Total CRE | 2,733,833 | 2,451,754 |
| Commercial: | | |
| Owner occupied CRE | 1,304,224 | 1,272,461 |
| Commercial & Industrial ("C&I") | 517,588 | 431,693 |
| Total commercial | 1,821,812 | 1,704,154 |
| Consumer | 768,359 | 674,961 |
| Gross loans receivable | 6,142,327 | 5,518,889 |
| Deferred loan costs (fees), net | 2,317 | (252) |
| Allowance for loan losses | (154,279) | (177,458) |
| Net loans receivable | \$5,990,365 | \$5,341,179 |

Gross loans pledged as collateral for borrowings from the FHLB and the Federal Reserve totaled \$3.61 billion and \$4.02 billion as of September 30, 2012 and December 31, 2011, respectively. As of September 30, 2012 and December 31, 2011, the unamortized portion of discounts on acquired loans was \$23.4 million and \$4.3 million, respectively.

Table of Contents

The following table sets forth details by segment for Sterling's loan portfolio and related allowance as of the balance sheet dates:

| | Residential Real Estate (in thousands) | Commercial Real Estate | Commercial | Consumer | Unallocated | Total |
|---------------------------------------|--|---------------------------|-------------|-----------|-------------|-------------|
| September 30, 2012 | | | | | | |
| Loans receivable, gross: | | | | | | |
| Individually evaluated for impairment | \$8,565 | \$82,543 | \$60,510 | \$827 | \$0 | \$152,445 |
| Collectively evaluated for impairment | 809,758 | 2,651,290 | 1,761,302 | 767,532 | 0 | 5,989,882 |
| Total loans receivable, gross | \$818,323 | \$2,733,833 | \$1,821,812 | \$768,359 | \$0 | \$6,142,327 |
| Allowance for loan losses: | | | | | | |
| Individually evaluated for impairment | \$365 | \$3,660 | \$6,036 | \$43 | \$0 | \$10,104 |
| Collectively evaluated for impairment | 10,383 | 53,518 | 35,479 | 19,949 | 24,846 | 144,175 |
| Total allowance for loan losses | \$10,748 | \$57,178 | \$41,515 | \$19,992 | \$24,846 | \$154,279 |
| December 31, 2011 | | | | | | |
| Loans receivable, gross: | | | | | | |
| Individually evaluated for impairment | \$18,301 | \$149,578 | \$74,041 | \$1,192 | \$0 | \$243,112 |
| Collectively evaluated for impairment | 669,719 | 2,302,176 | 1,630,113 | 673,769 | 0 | 5,275,777 |
| Total loans receivable, gross | \$688,020 | \$2,451,754 | \$1,704,154 | \$674,961 | \$0 | \$5,518,889 |
| Allowance for loan losses: | | | | | | |
| Individually evaluated for impairment | \$872 | \$11,170 | \$4,206 | \$57 | \$0 | \$16,305 |
| Collectively evaluated for impairment | 14,325 | 80,552 | 33,840 | 13,370 | 19,066 | 161,153 |
| Total allowance for loan losses | \$15,197 | \$91,722 | \$38,046 | \$13,427 | \$19,066 | \$177,458 |

Table of Contents

The following tables present a roll-forward by segment of the allowance for credit losses for the periods presented:

| | Residential Real Estate (in thousands) | Commercial Real Estate | Commercial | Consumer | Unallocated | Total |
|---|--|---------------------------|------------|-----------|-------------|-----------|
| 2012 third quarter activity | | | | | | |
| Allowance for loan losses: | | | | | | |
| Beginning balance, July 1 | \$12,381 | \$66,852 | \$40,270 | \$16,959 | \$21,782 | \$158,244 |
| Provisions | (129) |) (8,349) |) 2,762 | 4,652 | 3,064 | 2,000 |
| Charge-offs | (1,641) |) (4,898) |) (2,058) |) (1,882) |) 0 | (10,479) |
| Recoveries | 137 | 3,573 | 541 | 263 | 0 | 4,514 |
| Ending balance, September 30 | 10,748 | 57,178 | 41,515 | 19,992 | 24,846 | 154,279 |
| Reserve for unfunded credit commitments: | | | | | | |
| Beginning balance, July 1 | 2,321 | 698 | 3,350 | 1,510 | 73 | 7,952 |
| Provisions | 66 | (427) |) (1) |) 165 | 197 | 0 |
| Charge-offs | (181) |) 0 | 0 | 0 | 0 | (181) |
| Recoveries | 0 | 0 | 0 | 0 | 0 | 0 |
| Ending balance, September 30 | 2,206 | 271 | 3,349 | 1,675 | 270 | 7,771 |
| Total credit allowance | \$12,954 | \$57,449 | \$44,864 | \$21,667 | \$25,116 | \$162,050 |
| 2011 third quarter activity | | | | | | |
| Allowance for loan losses: | | | | | | |
| Beginning balance, July 1 | \$20,826 | \$102,607 | \$46,602 | \$13,800 | \$28,253 | \$212,088 |
| Provisions | 3,250 | 4,823 | (4,525) |) 902 | (450) |) 4,000 |
| Charge-offs | (4,204) |) (26,650) |) (7,769) |) (2,554) |) 0 | (41,177) |
| Recoveries | 178 | 6,781 | 3,862 | 463 | 0 | 11,284 |
| Ending balance, September 30 | 20,050 | 87,561 | 38,170 | 12,611 | 27,803 | 186,195 |
| Reserve for unfunded credit commitments: | | | | | | |
| Beginning balance, July 1 | 2,435 | 2,555 | 924 | 2,108 | (591) |) 7,431 |
| Provisions | 624 | (387) |) 613 | (383) |) 1,533 | 2,000 |
| Charge-offs | (55) |) 0 | 0 | 0 | 0 | (55) |
| Recoveries | 0 | 0 | 0 | 0 | 0 | 0 |
| Ending balance, September 30 | 3,004 | 2,168 | 1,537 | 1,725 | 942 | 9,376 |
| Total credit allowance | \$23,054 | \$89,729 | \$39,707 | \$14,336 | \$28,745 | \$195,571 |

Table of Contents

| | Residential Real Estate (in thousands) | Commercial Real Estate | Commercial | Consumer | Unallocated | Total |
|--|--|---------------------------|------------|-----------|-------------|------------|
| 2012 year to date | | | | | | |
| Allowance for loan losses: | | | | | | |
| Beginning balance, January 1 | \$ 15,197 | \$ 91,722 | \$ 38,046 | \$ 13,427 | \$ 19,066 | \$ 177,458 |
| Provisions | (1,486 |) (21,078 |) 13,442 | 11,342 | 5,780 | 8,000 |
| Charge-offs | (3,985 |) (25,897 |) (15,197 |) (5,977 |) 0 | (51,056 |
| Recoveries | 1,022 | 12,431 | 5,224 | 1,200 | 0 | 19,877 |
| Ending balance, September 30 | 10,748 | 57,178 | 41,515 | 19,992 | 24,846 | 154,279 |
| Reserve for unfunded credit commitments: | | | | | | |
| Beginning balance, January 1 | 3,828 | 2,321 | 1,796 | 1,787 | 297 | 10,029 |
| Provisions | 2,636 | (2,050 |) 1,553 | (112 |) (27 |) 2,000 |
| Charge-offs | (4,258 |) 0 | 0 | 0 | 0 | (4,258 |
| Recoveries | 0 | 0 | 0 | 0 | 0 | 0 |
| Ending balance, September 30 | 2,206 | 271 | 3,349 | 1,675 | 270 | 7,771 |
| Total credit allowance | \$ 12,954 | \$ 57,449 | \$ 44,864 | \$ 21,667 | \$ 25,116 | \$ 162,050 |
| 2011 year to date | | | | | | |
| Allowance for loan losses: | | | | | | |
| Beginning balance, January 1 | \$ 17,307 | \$ 124,907 | \$ 56,951 | \$ 14,645 | \$ 33,246 | \$ 247,056 |
| Provisions | 16,941 | 14,280 | (2,640 |) 3,362 | (5,443 |) 26,500 |
| Charge-offs | (15,230 |) (66,595 |) (21,261 |) (6,817 |) 0 | (109,903 |
| Recoveries | 1,032 | 14,969 | 5,120 | 1,421 | 0 | 22,542 |
| Ending balance, September 30 | 20,050 | 87,561 | 38,170 | 12,611 | 27,803 | 186,195 |
| Reserve for unfunded credit commitments: | | | | | | |
| Beginning balance, January 1 | 3,189 | 4,157 | 1,515 | 817 | 1,029 | 10,707 |
| Provisions | 646 | (1,989 |) 22 | 908 | (87 |) (500 |
| Charge-offs | (831 |) 0 | 0 | 0 | 0 | (831 |
| Recoveries | 0 | 0 | 0 | 0 | 0 | 0 |
| Ending balance, September 30 | 3,004 | 2,168 | 1,537 | 1,725 | 942 | 9,376 |
| Total credit allowance | \$ 23,054 | \$ 89,729 | \$ 39,707 | \$ 14,336 | \$ 28,745 | \$ 195,571 |

Table of Contents

In establishing the allowance for loan losses, Sterling groups its loan portfolio into segments for homogeneous loans. The groups are further segregated based on internal risk ratings. Both qualitative and quantitative data are considered in determining the probability of default and loss given default for each group of loans. The probability of default and loss given default are used to calculate an expected loss rate which is multiplied by the loan balance in each category to determine the general allowance for loan losses. If a loan is determined to be impaired, Sterling prepares an individual evaluation of the loan. The individual evaluation compares the present value of the expected future cash flows or the fair value of the underlying collateral to the recorded investment in the loan. The results of the individual impairment evaluation could determine the need to record a charge-off or establish a specific reserve.

Sterling assigns risk rating classifications to its loans. These risk ratings are divided into the following groups:

Pass-asset is considered of sufficient quality to preclude a Special Mention or an adverse rating. Pass assets generally are well protected by the current net worth and paying capacity of the obligor or by the value of the asset or underlying collateral.

Special Mention-asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in Sterling's credit position at some future date. Special Mention assets are not adversely classified and do not expose Sterling to sufficient risk to warrant adverse classification.

Substandard-asset is inadequately protected by the current net worth and paying capacity of the obligor or by the collateral pledged, if any. Assets so classified have well-defined weaknesses. They are characterized by the distinct possibility that Sterling may sustain some loss if the deficiencies are not corrected.

Doubtful/Loss-a Doubtful asset has the weaknesses of those classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. An asset classified Loss is considered uncollectible and/or of such little value that its continuance as an asset, without a charge-off or establishment of a specific reserve, is not warranted. This classification does not necessarily mean that an asset has absolutely no recovery or salvage value; but rather, it is not practical or desirable to defer writing off an asset that is no longer deemed to have financial value, even though partial recovery may be recognized in the future.

Table of Contents

The following table presents credit quality indicators for Sterling's loan portfolio grouped according to internally assigned risk ratings and performance status:

| | Residential Real Estate (in thousands) | Commercial Real Estate Investor CRE | Multifamily | Construction | Commercial Owner Occupied CRE | Commercial & Industrial | Consumer | Total | % of Total | |
|-----------------------|---|---|-------------|--------------|--|-------------------------------|-----------|-------------|---------------|---|
| September 30, 2012 | | | | | | | | | | |
| Pass | \$779,226 | \$1,085,091 | \$1,337,555 | \$71,752 | \$1,160,239 | \$470,667 | \$756,162 | \$5,660,692 | 93 | % |
| Special mention | 13,181 | 122,333 | 10,948 | 3,857 | 71,110 | 35,051 | 4,735 | 261,215 | 4 | % |
| Substandard | 25,551 | 64,811 | 10,001 | 23,825 | 66,839 | 11,870 | 7,419 | 210,316 | 3 | % |
| Doubtful/Loss | 365 | 2,539 | 1,002 | 119 | 6,036 | 0 | 43 | 10,104 | 0 | % |
| Total | \$818,323 | \$1,274,774 | \$1,359,506 | \$99,553 | \$1,304,224 | \$517,588 | \$768,359 | \$6,142,327 | 100 | % |
| Restructured | \$22,131 | \$4,339 | \$3,567 | \$13,176 | \$20,689 | \$1,966 | \$475 | \$66,343 | 1 | % |
| Nonaccrual | 21,095 | 48,779 | 5,654 | 14,286 | 42,746 | 7,944 | 5,591 | 146,095 | 2 | % |
| Nonperforming | 43,226 | 53,118 | 9,221 | 27,462 | 63,435 | 9,910 | 6,066 | 212,438 | 3 | % |
| Performing | 775,097 | 1,221,656 | 1,350,285 | 72,091 | 1,240,789 | 507,678 | 762,293 | 5,929,889 | 97 | % |
| Total | \$818,323 | \$1,274,774 | \$1,359,506 | \$99,553 | \$1,304,224 | \$517,588 | \$768,359 | \$6,142,327 | 100 | % |
| December 31, 2011 | | | | | | | | | | |
| Pass | \$643,071 | \$1,116,991 | \$975,583 | \$51,284 | \$1,123,796 | \$385,643 | \$663,829 | \$4,960,197 | 90 | % |
| Special mention | 14,031 | 83,372 | 9,901 | 24,578 | 54,009 | 25,334 | 4,166 | 215,391 | 4 | % |
| Substandard | 30,046 | 70,412 | 15,279 | 93,185 | 90,613 | 19,355 | 6,909 | 325,799 | 6 | % |
| Doubtful/Loss | 872 | 4,892 | 716 | 5,561 | 4,043 | 1,361 | 57 | 17,502 | 0 | % |
| Total | \$688,020 | \$1,275,667 | \$1,001,479 | \$174,608 | \$1,272,461 | \$431,693 | \$674,961 | \$5,518,889 | 100 | % |
| Restructured | \$17,638 | \$4,366 | \$0 | \$38,833 | \$13,519 | \$2,583 | \$0 | \$76,939 | 1 | % |
| Nonaccrual | 25,265 | 47,827 | 5,867 | 56,385 | 59,752 | 9,296 | 5,829 | 210,221 | 4 | % |
| Nonperforming | 42,903 | 52,193 | 5,867 | 95,218 | 73,271 | 11,879 | 5,829 | 287,160 | 5 | % |
| Performing | 645,117 | 1,223,474 | 995,612 | 79,390 | 1,199,190 | 419,814 | 669,132 | 5,231,729 | 95 | % |
| Total | \$688,020 | \$1,275,667 | \$1,001,479 | \$174,608 | \$1,272,461 | \$431,693 | \$674,961 | \$5,518,889 | 100 | % |

Table of Contents

Aging by class for Sterling's loan portfolio as of September 30, 2012 and December 31, 2011 was as follows:

| | Residential Real Estate (in thousands) | Commercial Investor CRE | Commercial Real Estate Multifamily | Commercial Construction | Commercial Owner Occupied CRE | Commercial & Industrial | Commercial Consumer | Total | % of Total | |
|---------------------------|---|-------------------------------|---------------------------------------|----------------------------|--|-------------------------------|------------------------|-------------|---------------|---|
| September 30, 2012 | | | | | | | | | | |
| 30 - 59 days past due | \$5,742 | \$12,602 | \$709 | \$72 | \$9,161 | \$1,612 | \$6,509 | \$36,407 | 1 | % |
| 60 - 89 days past due | 3,670 | 6,806 | 230 | 4,347 | 2,154 | 819 | 1,458 | 19,484 | 0 | % |
| > 90 days past due | 19,155 | 26,678 | 3,241 | 10,260 | 32,178 | 4,128 | 5,298 | 100,938 | 2 | % |
| Total past due | 28,567 | 46,086 | 4,180 | 14,679 | 43,493 | 6,559 | 13,265 | 156,829 | 3 | % |
| Current | 789,756 | 1,228,688 | 1,355,326 | 84,874 | 1,260,731 | 511,029 | 755,094 | 5,985,498 | 97 | % |
| Total Loans | \$818,323 | \$1,274,774 | \$1,359,506 | \$99,553 | \$1,304,224 | \$517,588 | \$768,359 | \$6,142,327 | 100 | % |
| > 90 days and accruing | \$0 | \$0 | \$0 | \$0 | \$0 | \$0 | \$0 | \$0 | 0 | % |
| December 31, 2011 | | | | | | | | | | |
| 30 - 59 days past due | \$5,718 | \$3,354 | \$1,523 | \$11,830 | \$19,967 | \$1,741 | \$4,167 | \$48,300 | 1 | % |
| 60 - 89 days past due | 4,585 | 3,954 | 193 | 879 | 4,233 | 520 | 2,258 | 16,622 | 0 | % |
| > 90 days past due | 20,207 | 33,759 | 3,178 | 68,024 | 40,987 | 7,871 | 5,054 | 179,080 | 3 | % |
| Total past due | 30,510 | 41,067 | 4,894 | 80,733 | 65,187 | 10,132 | 11,479 | 244,002 | 4 | % |
| Current | 657,510 | 1,234,600 | 996,585 | 93,875 | 1,207,274 | 421,561 | 663,482 | 5,274,887 | 96 | % |
| Total Loans | \$688,020 | \$1,275,667 | \$1,001,479 | \$174,608 | \$1,272,461 | \$431,693 | \$674,961 | \$5,518,889 | 100 | % |
| > 90 days and accruing | \$0 | \$0 | \$0 | \$0 | \$0 | \$0 | \$0 | \$0 | 0 | % |

Table of Contents

Sterling considers its nonperforming loans to be impaired loans. The following table summarizes impaired loans by class as of September 30, 2012 and December 31, 2011:

| | Unpaid Principal Balance (in thousands) | Charge-Offs | Book Balance Without Specific Reserve | With Specific Reserve | Specific Reserve |
|-------------------------|--|-------------|--|-----------------------------|---------------------|
| September 30, 2012 | | | | | |
| Residential real estate | \$49,633 | \$6,407 | \$42,861 | \$365 | \$365 |
| CRE: | | | | | |
| Investor CRE | 61,789 | 8,671 | 39,481 | 13,637 | 2,539 |
| Multifamily | 10,358 | 1,137 | 5,877 | 3,344 | 1,002 |
| Construction | 44,692 | 17,230 | 25,990 | 1,472 | 119 |
| Total CRE | 116,839 | 27,038 | 71,348 | 18,453 | 3,660 |
| Commercial: | | | | | |
| Owner Occupied CRE | 69,232 | 5,797 | 44,846 | 18,589 | 6,036 |
| C&I | 22,935 | 13,025 | 9,910 | 0 | 0 |
| Total commercial | 92,167 | 18,822 | 54,756 | 18,589 | 6,036 |
| Consumer | 6,361 | 295 | 5,617 | 449 | 43 |
| Total | \$265,000 | \$52,562 | \$174,582 | \$37,856 | \$10,104 |
| | Unpaid Principal Balance (in thousands) | Charge-Offs | Book Balance Without Specific Reserve | With Specific Reserve | Specific Reserve |
| December 31, 2011 | | | | | |
| Residential real estate | \$52,023 | \$9,120 | \$38,519 | \$4,384 | \$872 |
| CRE: | | | | | |
| Investor CRE | 70,517 | 18,324 | 31,503 | 20,690 | 4,892 |
| Multifamily | 6,185 | 318 | 4,496 | 1,371 | 716 |
| Construction | 133,588 | 38,370 | 43,281 | 51,937 | 5,562 |
| Total CRE | 210,290 | 57,012 | 79,280 | 73,998 | 11,170 |
| Commercial: | | | | | |
| Owner Occupied CRE | 89,604 | 16,333 | 48,194 | 25,077 | 4,043 |
| C&I | 25,497 | 13,618 | 11,207 | 672 | 163 |
| Total commercial | 115,101 | 29,951 | 59,401 | 25,749 | 4,206 |
| Consumer | 6,613 | 784 | 5,246 | 583 | 57 |
| Total | \$384,027 | \$96,867 | \$182,446 | \$104,714 | \$16,305 |

Table of Contents

The following table presents the average book balance and interest income recognized for impaired loans by class for the periods presented:

| | Three Months Ended September 30, 2012 | | 2011 | |
|-------------------------|---|-------------------------------|-------------------------|-------------------------------|
| | Average Book Balance (in thousands) | Interest Income Recognized | Average Book Balance | Interest Income Recognized |
| Residential real estate | \$43,393 | \$170 | \$51,786 | \$247 |
| Investor CRE | 63,746 | 278 | 58,185 | 620 |
| Multifamily | 17,865 | 55 | 7,206 | 67 |
| Construction | 30,152 | 692 | 142,356 | 1,146 |
| Owner Occupied CRE | 68,270 | 316 | 80,913 | 723 |
| C&I | 10,137 | 51 | 13,544 | 80 |
| Consumer | 5,327 | 4 | 5,635 | 0 |
| Total | \$238,890 | \$1,566 | \$359,625 | \$2,883 |
| | Nine Months Ended September 30, 2012 | | 2011 | |
| | Average Book Balance (in thousands) | Interest Income Recognized | Average Book Balance | Interest Income Recognized |
| Residential real estate | \$43,065 | \$588 | \$70,286 | \$567 |
| Investor CRE | 52,656 | 1,281 | 83,024 | 1,848 |
| Multifamily | 7,544 | 405 | 14,419 | 690 |
| Construction | 61,340 | 1,565 | 222,280 | 1,190 |
| Owner Occupied CRE | 68,353 | 1,722 | 79,218 | 1,913 |
| C&I | 10,895 | 86 | 12,823 | 321 |
| Consumer | 5,947 | 4 | 6,839 | 0 |
| Total | \$249,800 | \$5,651 | \$488,889 | \$6,529 |

The following tables present loans that were modified and recorded as troubled debt restructurings (“TDR’s”) during the following period:

| | Three Months Ended September 30, 2012 | | |
|-------------------------|--|--|---|
| | Number of Contracts (in thousands, except number of contracts) | Pre-Modification Recorded Investment | Post-Modification Recorded Investment |
| Residential real estate | 15 | \$2,817 | \$2,765 |
| Investor CRE | 0 | 0 | 0 |
| Multifamily | 0 | 0 | 0 |
| Construction | 2 | 4,118 | 3,241 |
| Owner Occupied CRE | 1 | 133 | 125 |
| C&I | 0 | 0 | 0 |
| Consumer | 1 | 172 | 173 |
| Total ⁽¹⁾ | 19 | \$7,240 | \$6,304 |

Table of Contents

| | Nine Months Ended September 30, 2012 | | |
|-------------------------|--|--|---|
| | Number of Contracts | Pre-Modification Recorded Investment | Post-Modification Recorded Investment |
| | (in thousands, except number of contracts) | | |
| Residential real estate | 27 | \$5,051 | \$4,993 |
| Investor CRE | 1 | 1,302 | 1,302 |
| Multifamily | 2 | 2,379 | 2,374 |
| Construction | 4 | 10,062 | 9,194 |
| Owner Occupied CRE | 10 | 15,574 | 15,515 |
| C&I | 9 | 3,482 | 2,206 |
| Consumer | 3 | 468 | 472 |
| Total ⁽¹⁾ | 56 | \$38,318 | \$36,056 |

(1) Amounts exclude specific loan loss reserves.

Substantially all TDRs are determined to be impaired prior to being restructured. As such, they are individually evaluated for impairment, unless they are considered homogeneous loans in which case they are collectively evaluated for impairment. As of September 30, 2012, Sterling had specific reserves of \$2.2 million on TDRs which were restructured during the previous nine months. There were 16 loans totaling \$25.1 million that were removed from TDR status during this period, as they had met the conditions for removal by achieving twelve consecutive months of performance at market equivalent rates of interest. The following table shows the post-modification recorded investment by class for TDRs restructured during the nine months ended September 30, 2012 by the primary type of concession granted:

| | Principal Deferral | Rate Reduction | Extension of Terms | Forgiveness of Principal and/or Interest | Total |
|-------------------------|-----------------------|-------------------|-----------------------|---|----------|
| | (in thousands) | | | | |
| Residential Real Estate | \$407 | \$4,586 | \$0 | \$0 | \$4,993 |
| Investor CRE | 0 | 1,302 | 0 | 0 | 1,302 |
| Multifamily | 0 | 2,374 | 0 | 0 | 2,374 |
| Construction | 0 | 3,261 | 5,933 | 0 | 9,194 |
| Owner CRE | 5,813 | 9,393 | 0 | 309 | 15,515 |
| C&I | 0 | 1,317 | 183 | 706 | 2,206 |
| Consumer | 0 | 173 | 299 | 0 | 472 |
| | \$6,220 | \$22,406 | \$6,415 | \$1,015 | \$36,056 |

Restructurings that result in the forgiveness of principal or interest are typically part of a bankruptcy settlement. There were no TDR's completed during the twelve month period ended September 30, 2012 that subsequently defaulted during the nine months ended September 30, 2012.

5. Goodwill and Other Intangible Assets:

Goodwill represents the excess of a purchase price over the net assets acquired. The following table presents a roll-forward of Sterling's goodwill:

| | Amount |
|------------------------------------|--------|
| Beginning balance, January 1, 2012 | \$0 |
| Acquired | 22,577 |

Ending balance, September 30, 2012

\$22,577

Table of Contents

Goodwill acquired during 2012 was related to the First Independent transaction and has been allocated to the Community Banking segment. Goodwill is not amortized, but is reviewed for impairment at least annually. Other intangible assets at September 30, 2012 were comprised of core deposit intangibles from various acquisitions, and other identifiable intangibles related to First Independent's trust and wealth management business. The following table provides details of other intangible assets:

| | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount |
|--------------------------|-----------------------|--------------------------|---------------------|
| September 30, 2012 | (in thousands) | | |
| Core deposit intangibles | \$55,420 | \$36,273 | \$19,147 |
| Other | 1,800 | 83 | 1,717 |
| December 31, 2011 | | | |
| Core deposit intangibles | 43,446 | 31,368 | 12,078 |
| Other | 0 | 0 | 0 |

The following table provides the projected core deposit and other intangibles amortization expense for the remainder of 2012 and the next five years:

| | Amount |
|--------------------------|---------|
| Remainder of 2012 | \$1,792 |
| Years ended December 31, | |
| 2013 | 6,430 |
| 2014 | 3,339 |
| 2015 | 2,361 |
| 2016 | 1,271 |
| 2017 | 1,178 |

6. Junior Subordinated Debentures:

Sterling has raised regulatory capital through the formation of trust subsidiaries and has assumed similar obligations through mergers with other financial institutions. The trusts are business trusts in which Sterling owns all of the common equity. The proceeds from the sale of the securities were used to purchase junior subordinated debentures issued by Sterling. Sterling's obligations under the junior subordinated debentures and related documents, taken together, constitute a full and unconditional guarantee by Sterling of the trusts' obligations. The junior subordinated debentures are treated as debt of Sterling. The junior subordinated debentures mature 30 years after issuance, and are redeemable, subject to certain conditions. As of September 30, 2012, all of Sterling's junior subordinated debentures were redeemable at par, at their applicable quarterly or semiannual interest payment dates. During the third quarter of 2009, Sterling elected to defer regularly scheduled interest payments on its junior subordinated debentures. In June 2012, Sterling elected to resume regularly scheduled interest payments and as a result, the deferred accrued interest in the amount of \$19.6 million was paid in full.

Table of Contents

Details of the junior subordinated debentures are as follows:

| Subsidiary Issuer | Issue Date (in thousands) | Maturity Date | Next Interest Payment Date | September 30, 2012 | |
|---------------------------------------|------------------------------|---------------|----------------------------|--------------------|-------------|
| | | | | Rate | Amount |
| Sterling Capital Trust IX | July 2007 | Oct 2037 | Jan 2013 | 1.86% | \$46,392 |
| Sterling Capital Trust VIII | Sept 2006 | Dec 2036 | Dec 2012 | 2.02 | 51,547 |
| Sterling Capital Trust VII | June 2006 | June 2036 | Dec 2012 | 1.91 | 56,702 |
| Lynnwood Financial Statutory Trust II | June 2005 | June 2035 | Dec 2012 | 2.19 | 10,310 |
| Sterling Capital Trust VI | June 2003 | Sept 2033 | Dec 2012 | 3.59 | 10,310 |
| Sterling Capital Statutory Trust V | May 2003 | June 2033 | Dec 2012 | 3.62 | 20,619 |
| Sterling Capital Trust IV | May 2003 | May 2033 | Nov 2012 | 3.58 | 10,310 |
| Sterling Capital Trust III | April 2003 | April 2033 | Jan 2013 | 3.69 | 14,433 |
| Lynnwood Financial Statutory Trust I | Mar 2003 | Mar 2033 | Dec 2012 | 3.52 | 9,440 |
| Klamath First Capital Trust I | July 2001 | July 2031 | Jan 2013 | 4.48 | 15,230 |
| | | | | 2.55% | * \$245,293 |

* Weighted average rate.

7. Earnings Per Share:

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|------------|------------------------------------|------------|
| | 2012 | 2011 | 2012 | 2011 |
| | (in thousands, except shares and per share amounts) | | | |
| Numerator: | | | | |
| Net income | \$30,598 | \$11,328 | \$364,775 | \$24,300 |
| Denominator: | | | | |
| Weighted average shares outstanding - basic | 62,139,833 | 61,958,183 | 62,110,498 | 61,944,392 |
| Dilutive securities outstanding | 706,031 | 83,020 | 634,679 | 292,073 |
| Weighted average shares outstanding - diluted | 62,845,864 | 62,041,203 | 62,745,177 | 62,236,465 |
| Earnings per share - basic | \$0.49 | \$0.18 | \$5.87 | \$0.39 |
| Earnings per share - diluted | \$0.49 | \$0.18 | \$5.81 | \$0.39 |
| Antidilutive securities outstanding (weighted average): | | | | |
| Stock options | 13,054 | 16,291 | 14,174 | 16,823 |
| Restricted shares | 0 | 9,049 | 9,249 | 63,405 |
| Total antidilutive securities outstanding | 13,054 | 25,340 | 23,423 | 80,228 |

Sterling's dilutive securities outstanding include warrants held by certain investors. On September 19, 2012, Sterling repurchased a warrant for 97,541 shares held by the United States Department of the Treasury ("Treasury"). The warrant had been issued to Treasury on December 5, 2008, in connection with Sterling's participation in the Capital Purchase Program of the Troubled Asset Relief Program. Sterling repurchased the warrant for \$825,000, which was cancelled upon repurchase. Treasury sold all of its Sterling common stock on August 14, 2012 in an underwritten public offering.

Table of Contents

8. Noninterest Expense:

The following table details the components of Sterling's noninterest expense:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|----------|------------------------------------|-----------|
| | 2012 | 2011 | 2012 | 2011 |
| | (in thousands) | | | |
| Employee compensation and benefits | \$45,636 | \$43,828 | \$139,502 | \$129,514 |
| OREO operations | 4,008 | 10,739 | 9,337 | 36,591 |
| Occupancy and equipment | 11,034 | 9,580 | 32,253 | 29,558 |
| Data processing | 7,137 | 5,651 | 20,600 | 18,339 |
| FDIC insurance | 2,159 | 3,510 | 6,005 | 10,903 |
| Professional fees | 4,929 | 3,161 | 12,718 | 9,571 |
| Depreciation | 2,918 | 3,000 | 8,754 | 9,026 |
| Advertising | 3,442 | 1,932 | 10,370 | 6,659 |
| Travel and entertainment | 1,420 | 1,336 | 4,019 | 3,931 |
| Merger and acquisition | 1,584 | 0 | 9,981 | 0 |
| Amortization of other intangible assets | 1,792 | 1,190 | 4,988 | 3,639 |
| Other | 3,349 | 2,693 | 7,137 | 8,784 |
| Total noninterest expense | \$89,408 | \$86,620 | \$265,664 | \$266,515 |

9. Income Taxes:

During the three months ended September 30, 2012, Sterling did not recognize any federal or state income tax expense, while during the nine months ended September 30, 2012, Sterling recorded a \$288.8 million income tax benefit, which was the result of reversing substantially all of the deferred tax asset valuation allowance. Sterling did not recognize any federal or state income tax expense during the comparable periods of 2011. As of September 30, 2012, the net deferred tax asset was \$280.4 million, including \$273.0 million of net operating loss and tax credit carry-forwards. As of December 31, 2011, Sterling had a fully reserved net deferred tax asset of \$327.0 million, including \$285.0 million of net operating loss and tax credit carry-forwards.

The deferred tax asset valuation allowance was established during 2009 due to the three year cumulative loss and uncertainty at that time regarding Sterling's ability to generate future taxable income. Reversal of the deferred tax asset valuation allowance occurred during the quarter ended June 30, 2012, which marked the sixth consecutive quarter of profitability for Sterling. Prior to reversing the allowance, management analyzed both positive and negative evidence that could affect the realization of the deferred tax asset. Based on the earnings performance trend and projections of income through 2013, improvement in asset quality, higher net interest margin and improvements in other key financial ratios, expectations of continued profitability, the length of the carry-forward period for its net operating losses and tax credits, an analysis of the reversal of existing temporary differences, and an evaluation of its loss carry-back ability and tax planning strategies, Sterling determined that it was more likely than not that the net deferred tax asset would be realized. This assessment was updated as of September 30, 2012, resulting in the same conclusion.

With regard to the deferred tax asset, the benefits of Sterling's accumulated tax losses would be reduced in the event of an "ownership change," as determined under Section 382 of the Internal Revenue Code. During 2010, in order to preserve the benefits of these tax losses, Sterling's shareholders approved a protective amendment to the restated articles of incorporation and Sterling's board adopted a tax preservation rights plan, both of which restrict certain stock transfers that would result in an investor acquiring more than 4.95% of Sterling's total outstanding common stock.

Table of Contents

10. Stock Based Compensation:

The following table presents a summary of restricted stock and units activity during the period:

| | Shares | Weighted Average Grant Price |
|---------------------------------|---------|------------------------------------|
| Balance, January 1, 2012 | 301,373 | \$17.82 |
| Granted | 260,846 | 19.86 |
| Vested | (58,292 |) 23.43 |
| Expired | 0 | 0.00 |
| Forfeited | (76,974 |) 17.02 |
| Outstanding, September 30, 2012 | 426,953 | \$18.45 |

The following table presents a summary of stock option activity during the period:

| | Shares | Weighted Average Exercise Price |
|---------------------------------|--------|--|
| Balance, January 1, 2012 | 15,800 | \$1,393.65 |
| Granted | 0 | 0.00 |
| Exercised | 0 | 0.00 |
| Expired | (973 |) 1,519.35 |
| Cancelled | (1,954 |) 1,247.21 |
| Outstanding, September 30, 2012 | 12,873 | \$1,406.37 |
| Exercisable, September 30, 2012 | 12,470 | \$1,447.88 |

The following table presents the weighted average remaining contractual life and the aggregate intrinsic value for stock options as of the dates indicated:

| | Stock Options Outstanding Weighted Average Life | Intrinsic Value | Exercisable Weighted Average Life | Intrinsic Value |
|--------------------|--|--------------------|---|--------------------|
| September 30, 2012 | 1.5 years | \$0 | 1.5 years | \$0 |
| December 31, 2011 | 2.1 years | 0 | 2.1 years | 0 |

As of September 30, 2012, a total of 5,398,091 shares remained available for grant under Sterling's 2003, 2007 and 2010 Long-Term Incentive Plans. The stock options granted under these plans have terms of four, six, eight and 10 years. Stock based compensation expense recognized during the periods presented was as follows:

| | Nine Months Ended September 30, | |
|------------------|---------------------------------|---------|
| | 2012 | 2011 |
| | (in thousands) | |
| Stock options | \$37 | \$226 |
| Restricted stock | 2,719 | 2,723 |
| Total | \$2,756 | \$2,949 |

As of September 30, 2012, unrecognized equity compensation expense totaled \$5.5 million as the underlying outstanding awards had not yet been earned. This amount will be recognized over a weighted average period of 2.2 years.

Table of Contents

11. Derivatives and Hedging:

From time to time, Sterling enters into interest rate swap transactions with loan customers. The interest rate risk on these swap transactions is hedged by Sterling entering into offsetting interest rate swap agreements with various unaffiliated counterparties (“broker-dealers”). Both customer and broker-dealer related interest rate derivatives are carried at fair value, which includes consideration of counterparty credit risk.

As part of its mortgage banking activities, Sterling makes commitments to prospective borrowers on residential mortgage loan applications, which may have the interest rates locked for a period of 10 to 60 days or longer, if extended (“interest rate lock commitments”). The interest rate lock commitments fair valued below are exclusive of the anticipated fallout. These interest rate lock commitments, and loans held for sale that have not been committed to investors, give rise to interest rate risk. Sterling hedges the interest rate risk arising from these mortgage banking activities by entering into forward sales agreements on MBS with third parties (“forward commitments”).

Residential mortgage loans held for sale that were not committed to investors were \$279.6 million and \$192.4 million as of September 30, 2012 and December 31, 2011, respectively. The following table summarizes Sterling’s mortgage banking operations and interest rate swaps:

| | September 30, 2012 | | |
|-------------------------------------|--------------------|------------|-----------|
| | Notional | Fair Value | Liability |
| | (in thousands) | Asset | |
| Interest rate lock commitments, net | \$297,723 | \$20,452 | \$0 |
| Forward commitments | 476,500 | 0 | 12,458 |
| Interest rate swaps - broker-dealer | 40,303 | 0 | 2,415 |
| Interest rate swaps - customer | 42,877 | 2,392 | 0 |
| | December 31, 2011 | | |
| | Notional | Fair Value | Liability |
| | (in thousands) | Asset | |
| Interest rate lock commitments, net | \$181,456 | \$5,558 | \$0 |
| Forward commitments | 315,579 | 0 | 3,785 |
| Interest rate swaps - broker-dealer | 43,213 | 0 | 4,527 |
| Interest rate swaps - customer | 45,820 | 4,711 | 0 |

The fair value of these derivatives is included in other assets and liabilities, respectively. Gains and losses on Sterling’s mortgage banking derivative transactions are included in mortgage banking income, while gains and losses on Sterling’s interest rate swap agreements are included in other noninterest income. The following table sets forth these gains and losses:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|-----------------------------|----------------------------------|--------------|---------------------------------|--------------|
| | 2012 | 2011 | 2012 | 2011 |
| | (in thousands) | | | |
| Mortgage banking operations | \$ (2,694) |) \$ (2,116) |) \$ (3,349) |) \$ (5,015) |
| Other noninterest income | 80 | 1,191 | (600) |) 1,228 |

Table of Contents

12. Fair Value:

Fair value estimates are determined as of a specific date using quoted market prices, where available, or various assumptions and estimates. As the assumptions underlying these estimates change, the fair value of the financial instruments will change. The use of assumptions and various valuation techniques, as well as the absence of secondary markets for certain financial instruments, will likely reduce the comparability of fair value disclosures between financial institutions. Accordingly, the aggregate fair value amounts presented do not represent and should not be construed to represent the full underlying value of Sterling.

The carrying amounts and fair values of financial instruments as of the periods indicated were as follows. Other assets are comprised of FHLB stock and derivatives, while other liabilities are comprised of derivatives:

| | Level | September 30, 2012 | | December 31, 2011 | |
|---------------------------------|-------|--------------------|------------|-------------------|------------|
| | | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| Financial assets: | | | | | |
| Cash and cash equivalents | 1 | \$263,884 | \$263,884 | \$491,228 | \$491,228 |
| Investments and MBS: | | | | | |
| Available for sale | 2 | 2,049,961 | 2,049,961 | 2,547,876 | 2,547,876 |
| Held to maturity | 2 | 1,716 | 1,716 | 1,747 | 1,747 |
| Loans held for sale | 2 | 320,823 | 320,823 | 273,957 | 273,957 |
| Loans receivable, net | 3 | 5,990,365 | 6,016,644 | 5,341,179 | 5,347,555 |
| Other assets (1) | 2 | 121,187 | 121,187 | 109,317 | 109,317 |
| Financial liabilities: | | | | | |
| Non-maturity deposits | 2 | 4,690,350 | 4,690,350 | 3,824,948 | 3,824,948 |
| Deposits with stated maturities | 2 | 2,049,560 | 2,088,695 | 2,660,870 | 2,710,740 |
| Borrowings | 2 | 1,343,241 | 1,333,925 | 1,706,662 | 1,724,347 |
| Other liabilities | 2 | 14,873 | 14,873 | 9,212 | 9,212 |

(1) Other assets includes FHLB stock. As of September 30, 2012 and December 31, 2011, FHLB stock was carried at \$98.3 million and \$99.0 million, respectively.

Companies have the option of carrying financial assets and liabilities at fair value, which can be implemented on all or individually selected financial instruments. The framework for defining and measuring fair value requires that one of three valuation methods be used to determine fair market value: the market approach, the income approach or the cost approach. To increase consistency and comparability in fair value measurements and related disclosures, the standard also creates a fair value hierarchy to prioritize the inputs to these valuation methods into the following three levels:

Level 1 inputs are a select class of observable inputs, based upon the quoted prices for identical instruments in active markets that are accessible as of the measurement date, and are to be used whenever available.

Level 2 inputs are other types of observable inputs, such as quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are inactive; or other inputs that are observable or can be derived from or supported by observable market data. Level 2 inputs are to be used whenever Level 1 inputs are not available.

Level 3 inputs are substantially unobservable, reflecting the reporting entity's own assumptions regarding what market participants would assume when pricing a financial instrument. Level 3 inputs are to be used only when Level 1 and Level 2 inputs are unavailable.

The methods and assumptions used to estimate the fair value of certain financial instruments are as follows:

Cash and Cash Equivalents. The carrying value of cash and cash equivalents approximates fair value due to the relatively short-term nature of these instruments.

Table of Contents

Investments and MBS. The fair value of investments and MBS are provided by a third-party pricing service. These valuations are based on market data using pricing models that vary by asset class and incorporate available current trade, bid and other market information, and for structured securities, cash flow and loan performance data. The pricing processes utilize benchmark curves, benchmarking of similar securities, sector groupings, and matrix pricing. Option adjusted spread models are also used to assess the impact of changes in interest rates and to develop prepayment scenarios. All models and processes used take into account market convention.

Loans Held for Sale. Sterling has elected to carry residential loans held for sale at fair value. The fair values of residential loans are based on investor quotes in the secondary market, determined by the fair value of options and commitments to sell or issue mortgage loans. The fair value election was made to match changes in the value of these loans with the value of their economic hedges. Loan origination fees, costs and servicing rights, which were previously deferred on these loans, are now recognized as part of the loan value at origination. Nonresidential loans held for sale are carried at the lower of cost or market ("LOCOM") due to the frequency of these loan sale transactions, as well as the availability of market data for these loan types.

Loans Receivable. The fair value of performing loans is estimated by discounting the cash flows using interest rates that consider the current credit and interest rate risk inherent in the loans and current economic and lending conditions and does not incorporate the exit price concept of fair value. The fair value of nonperforming collateral-dependent loans is estimated based upon the value of the underlying collateral. The fair value of other nonperforming loans is estimated by discounting management's current estimate of future cash flows using a rate estimated to be commensurate with the risks involved. Changes in the various inputs in the fair value of nonperforming loans will have a significant impact on the fair value.

Mortgage Servicing Rights. The fair value of mortgage servicing rights is estimated using a discounted cash flow model to arrive at the net present value of expected earnings from the servicing of the loans. Model inputs include prepayment speeds, market interest rates, contractual interest rates on the loans being serviced, the amount of other fee income generated and other factors. The fair value of mortgage servicing rights is impacted by any changes in these inputs.

Deposits. The fair values of deposits subject to immediate withdrawal such as interest and noninterest bearing checking, regular savings, and money market deposit accounts, are equal to the amounts payable on demand at the reporting date. Fair values for time deposits are estimated by discounting future cash flows using interest rates currently offered on time deposits with similar remaining maturities.

Borrowings. The carrying amounts of short-term borrowings under repurchase agreements, federal funds purchased, short-term FHLB advances and other short-term borrowings approximate their fair values due to the relatively short period of time between the origination of the instruments and the expected payment dates on the instruments. The fair value of long-term FHLB advances and other long-term borrowings is estimated using discounted cash flow analysis based on Sterling's current incremental borrowing rates for similar types of borrowing arrangements with similar remaining terms.

Derivatives. Interest rate lock commitments and forward commitments valuations are estimated using quoted market prices for similar instruments. Fair values for the interest rate swaps are based on the present value differential between the fixed interest rate payments and the floating interest rate payments as projected by the forward interest rate curve, over the term of the swap, with the recorded amount net of any credit valuation adjustments.

Table of Contents

Assets and Liabilities Measured at Fair Value on a Recurring Basis

The following table presents Sterling's financial instruments that are measured at fair value on a recurring basis:

| | Total (in thousands) | Level 1 | Level 2 | Level 3 |
|--|-------------------------|---------|-------------|----------|
| September 30, 2012 | | | | |
| Investment securities available for sale: | | | | |
| MBS | \$1,825,448 | \$0 | \$1,825,448 | \$0 |
| Municipal bonds | 205,405 | 0 | 205,405 | 0 |
| Other | 19,108 | 0 | 19,108 | 0 |
| Total investment securities available for sale | 2,049,961 | 0 | 2,049,961 | 0 |
| Loans held for sale | 320,823 | 0 | 320,823 | 0 |
| Other assets - derivatives | 22,844 | 0 | 22,844 | 0 |
| Total assets | \$2,393,628 | \$0 | \$2,393,628 | \$0 |
| Contingent consideration | \$14,051 | \$0 | \$0 | \$14,051 |
| Other liabilities - derivatives | 14,873 | 0 | 14,873 | 0 |
| Total liabilities | \$28,924 | \$0 | \$14,873 | \$14,051 |
| December 31, 2011 | | | | |
| Investment securities available for sale: | | | | |
| MBS | \$2,320,934 | \$0 | \$2,320,934 | \$0 |
| Municipal bonds | 207,456 | 0 | 207,456 | 0 |
| Other | 19,486 | 0 | 19,486 | 0 |
| Total investment securities available for sale | 2,547,876 | 0 | 2,547,876 | 0 |
| Loans held for sale | 223,638 | 0 | 223,638 | 0 |
| Other assets - derivatives | 10,269 | 0 | 10,269 | 0 |
| Total assets | \$2,781,783 | \$0 | \$2,781,783 | \$0 |
| Other liabilities - derivatives | \$9,212 | \$0 | \$9,212 | \$0 |

Contingent consideration represents the estimated liability for additional payments related to the First Independent transaction based on the application of a discounted cash flow methodology. The following table presents a roll-forward of contingent consideration:

| | Three Months Ended September 30, 2012 (in thousands) | Nine Months Ended |
|---|--|-------------------|
| Beginning balance | \$13,292 | \$0 |
| Additions | 0 | 11,779 |
| Valuation adjustments - noninterest expense - other - mergers and acquisitions | 759 | 2,272 |
| Ending balance | \$14,051 | \$14,051 |

Table of Contents

Derivatives include mortgage banking interest rate lock and loan delivery commitments, interest rate swaps, and also at December 31, 2011 a common stock warrant carried as a derivative liability. See Note 11 for a further discussion of these derivatives. The difference between the aggregate fair value and the aggregate unpaid principal balance of loans held for sale that are carried at fair value were included in earnings as follows:

| | | |
|-----------------------------|---------------------------------|---------|
| | Nine Months Ended September 30, | |
| | 2012 | 2011 |
| | (in thousands) | |
| Mortgage banking operations | \$9,049 | \$8,542 |

Assets and Liabilities Measured at Fair Value on a Non-recurring Basis

Sterling may be required, from time to time, to measure certain assets at fair value on a non-recurring basis from application of LOCOM accounting or write-downs of individual assets. The following table presents the carrying value for these assets as of the dates indicated:

| | September 30, 2012 | | | | Losses During the Nine Months Ended September 30, 2012 |
|---------------------------|-------------------------|---------|---------|-----------|---|
| | Total Carrying Value | Level 1 | Level 2 | Level 3 | |
| | (in thousands) | | | | |
| Loans | \$167,951 | \$0 | \$0 | \$167,951 | \$ (25,960) |
| OREO | 24,344 | 0 | 0 | 24,344 | (3,232) |
| Mortgage servicing rights | 26,819 | 0 | 0 | 26,819 | (983) |
| | December 31, 2011 | | | | Losses |
| | Total Carrying Value | Level 1 | Level 2 | Level 3 | During the Twelve Months Ended December 31, 2011 |
| Loans | \$268,837 | \$0 | \$0 | \$268,837 | \$ (47,372) |
| OREO | 31,379 | 0 | 0 | 31,379 | (10,860) |
| Mortgage servicing rights | 23,102 | 0 | 0 | 23,102 | (6,191) |

The loans disclosed above represent the net balance of loans as of period end for which a charge-off or specific reserve has been recognized during the nine months ended September 30, 2012, and the year ended December 31, 2011, respectively, with these charges comprised of charge-offs and increases in the specific reserve. OREO represents the carrying value of properties for which a specific reserve was established during the periods presented as a result of updated appraisals subsequent to foreclosure. The appraisals may use comparable sales and income approach valuation methods and may be adjusted to reflect current market or property information. In addition to the loan and OREO losses disclosed above, charge-offs at foreclosure for properties held as of period end totaled \$8.8 million and \$20.9 million for the nine months ended September 30, 2012 and the year ended December 31, 2011, respectively. Fair value adjustments to the mortgage servicing rights were mainly due to market derived assumptions associated with mortgage prepayment speeds. Sterling carries its mortgage servicing rights at LOCOM, and they are accordingly measured at fair value on a non-recurring basis. Qualitative information regarding the fair value measurements for Level 3 financial instruments are as follows:

| | September 30, 2012 | |
|-------|--|--|
| | Method | Inputs |
| Loans | Income, Market, Comparable Sales, Discounted Cash Flows | External appraised values; probability weighting of broker price opinions; management assumptions regarding market |

| | | |
|---------------------------|---|---|
| OREO | Income, Market, Comparable Sales, Discounted Cash Flows | trends or other relevant factors; selling costs ranging from 4.5% to 9%. External appraised values; probability weighting of broker price opinions; management assumptions regarding market trends or other relevant factors; selling costs ranging from 4.5% to 9%. |
| Mortgage servicing rights | Discounted Cash Flow | Weighted average prepayment speed 20.2%; weighted average discount rate 10.1% |

Table of Contents

13. Regulatory Capital:

The following table sets forth the respective regulatory capital positions for Sterling and Sterling Bank as of September 30, 2012:

| | Actual | | Adequately Capitalized | | Well-Capitalized | | | |
|---------------------------------|--------------------------|-------|------------------------|-------|------------------|-------|---|--|
| | Amount (in thousands) | Ratio | Amount | Ratio | Amount | Ratio | | |
| Tier 1 leverage ratio | | | | | | | | |
| Sterling | \$1,136,913 | 12.7 | % \$358,636 | 4.0 | % \$448,295 | 5.0 | % | |
| Sterling Bank | 1,131,674 | 12.6 | % 360,756 | 4.0 | % 450,945 | 5.0 | % | |
| Tier 1 risk-based capital ratio | | | | | | | | |
| Sterling | 1,136,913 | 17.6 | % 258,113 | 4.0 | % 387,169 | 6.0 | % | |
| Sterling Bank | 1,131,674 | 17.5 | % 258,372 | 4.0 | % 387,559 | 6.0 | % | |
| Total risk-based capital ratio | | | | | | | | |
| Sterling | 1,218,578 | 18.9 | % 516,226 | 8.0 | % 645,282 | 10.0 | % | |
| Sterling Bank | 1,213,419 | 18.8 | % 516,745 | 8.0 | % 645,931 | 10.0 | % | |

14. Segment Information:

Sterling's operations are divided into two primary business segments that represent its core businesses:

Community Banking - providing traditional banking services through the retail banking, private banking and commercial banking groups, including the originating and servicing of commercial real estate, owner occupied CRE and C&I loans.

Home Loan Division - originating and selling residential real estate loans through its mortgage banking operations, on both a servicing-retained and servicing-released basis.

The Other and Eliminations caption represents intercompany eliminations. In 2012, Sterling combined its Commercial Real Estate and Community Banking segments to improve how it made decisions and measured the segments' performance. Segment results for the comparable period presented have been restated to reflect current period presentation.

| | As of and for the Three Months Ended September 30, 2012 | | | |
|-----------------------------------|---|--------------------|------------------------|-------------|
| | Community Banking (in thousands) | Home Loan Division | Other and Eliminations | Total |
| Interest income | \$87,930 | \$8,061 | \$0 | \$95,991 |
| Interest expense | 17,649 | 0 | 3,034 | 20,683 |
| Net interest income | 70,281 | 8,061 | (3,034) | 75,308 |
| Provision for credit losses | 1,980 | 20 | 0 | 2,000 |
| Noninterest income | 8,033 | 38,816 | (151) | 46,698 |
| Noninterest expense | 61,552 | 31,784 | (3,928) | 89,408 |
| Income (loss) before income taxes | \$14,782 | \$15,073 | \$743 | \$30,598 |
| Total assets | \$9,466,908 | \$4,633 | \$896 | \$9,472,437 |

Table of Contents

| | As of and for the Three Months Ended September 30, 2011 | | | |
|-----------------------------------|---|-----------------------|---------------------------|-------------|
| | Community Banking | Home Loan Division | Other and Eliminations | Total |
| | (in thousands) | | | |
| Interest income | \$101,385 | \$0 | \$(6 |) \$101,379 |
| Interest expense | 26,519 | 26 | (2 |) 26,543 |
| Net interest income | 74,866 | (26 |) (4 |) 74,836 |
| Provision for credit losses | 6,000 | 0 | 0 | 6,000 |
| Noninterest income | 11,459 | 17,649 | 4 | 29,112 |
| Noninterest expense | 70,353 | 16,267 | 0 | 86,620 |
| Income (loss) before income taxes | \$9,972 | \$1,356 | \$0 | \$11,328 |
| Total assets | \$9,154,384 | \$21,490 | \$0 | \$9,175,874 |

| | As of and for the Nine Months Ended September 30, 2012 | | | |
|-----------------------------------|--|-----------------------|---------------------------|-------------|
| | Community Banking | Home Loan Division | Other and Eliminations | Total |
| | (in thousands) | | | |
| Interest income | \$275,351 | \$19,595 | \$0 | \$294,946 |
| Interest expense | 61,383 | 0 | 4,992 | 66,375 |
| Net interest income | 213,968 | 19,595 | (4,992 |) 228,571 |
| Provision for credit losses | 9,980 | 20 | 0 | 10,000 |
| Noninterest income | 45,808 | 77,517 | (299 |) 123,026 |
| Noninterest expense | 202,455 | 66,548 | (3,339 |) 265,664 |
| Income (loss) before income taxes | \$47,341 | \$30,544 | \$(1,952 |) \$75,933 |
| Total assets | \$9,466,908 | \$4,633 | \$896 | \$9,472,437 |

| | As of and for the Nine Months Ended September 30, 2011 | | | |
|-----------------------------------|--|-----------------------|---------------------------|-------------|
| | Community Banking | Home Loan Division | Other and Eliminations | Total |
| | (in thousands) | | | |
| Interest income | \$304,769 | \$2,832 | \$(638 |) \$306,963 |
| Interest expense | 82,672 | 1,001 | (96 |) 83,577 |
| Net interest income | 222,097 | 1,831 | (542 |) 223,386 |
| Provision for credit losses | 26,056 | (56 |) 0 | 26,000 |
| Noninterest income | 56,618 | 36,297 | 514 | 93,429 |
| Noninterest expense | 229,747 | 36,768 | 0 | 266,515 |
| Income (loss) before income taxes | \$22,912 | \$1,416 | \$(28 |) \$24,300 |
| Total assets | \$9,154,384 | \$21,490 | \$0 | \$9,175,874 |

Table of Contents

15. Commitments and Contingencies:

On March 22, 2012, Sterling and its subsidiary Sterling Savings Bank were named as defendants in a purported class action lawsuit filed by a Washington customer of Sterling Savings Bank in King County, Washington, Superior Court, and on May 25, 2012, Sterling Savings Bank was named a defendant in a similar purported class action lawsuit filed on behalf of a customer in the U.S. District Court of Oregon. These suits challenged the manner in which overdraft fees were charged and the disclosures related to posting order of debit card and ATM transactions, and alleged claims for breach of contract, breach of the covenant of good faith and fair dealing, unconscionability, conversion, unjust enrichment, and a violation of state consumer protection laws. The two suits encompassed claims on behalf of Sterling Savings Bank customers from the five states in which Sterling Savings Bank presently conducts business. On October 17, 2012, Sterling announced the dismissal of the plaintiffs' claims.

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 9, 2010. On June 18, 2010, the lead plaintiff filed a consolidated complaint (the "Complaint"). The Complaint purports to be brought on behalf of a class of persons who purchased or otherwise acquired Sterling's stock during the period from July 23, 2008 to October 15, 2009. The Complaint alleges that defendants violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 by failing to disclose the extent of Sterling's delinquent commercial real estate, construction and land development loans, properly record losses for impaired loans, and properly reserve for loan losses, thereby causing Sterling's stock price to be artificially inflated during the purported class period. Plaintiffs seek unspecified damages and attorneys' fees and costs. Sterling believes the lawsuit is without merit and intends to defend against it vigorously. On August 30, 2010, Sterling moved to dismiss the Complaint. On March 2, 2011, after complete briefing, the court held a hearing on the motion to dismiss. The court has not yet issued an order on the motion, but recently indicated that it intends to do so in the near future. 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 reasonably 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 the 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 the Employee Retirement Income Security Act of 1974, as amended ("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. On September 26, 2012, Sterling received a letter from the U.S. Department of Labor (the "Department of Labor") containing similar allegations as those set forth in the Complaint, demanding that the violations alleged in the Department of Labor's letter be corrected and notifying Sterling that the Department of Labor may take legal action in

connection with such allegations, including assessing a civil money penalty. Sterling believes the Complaint, and Department of Labor allegations, are without merit and intends to defend against them vigorously. A hearing on the motion to dismiss the Complaint occurred on March 22, 2011, with the court indicating that it would take the motion under submission. The court has not yet issued an order on the motion, but recently indicated that it intends to do so in the near future. Failure by Sterling to obtain a favorable resolution of the claims set forth in the Complaint or in the letter from the Department of Labor 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 reasonably estimable in amount.

On June 29, 2012, Sterling Bank entered into a definitive agreement for the sale of its Montana operations to Eagle Bancorp Montana, Inc. and its wholly owned subsidiary American Federal Savings Bank. The transaction is subject to customary closing conditions, and is expected to be completed during the fourth quarter of 2012.

Table of Contents

16. Subsequent Events:

On October 22, 2012, Sterling entered into a definitive agreement with American Heritage Holdings ("AHH"), the holding company for Borrego Springs Bank, N.A., to acquire AHH for cash consideration of \$6.5 million. The transaction, which has been approved by the boards of directors of Sterling and AHH, is expected to provide a significant enhancement to Sterling's small business government guaranteed lending and servicing capabilities. The shareholders of AHH have agreed to vote in favor of the transaction, which is subject to regulatory approval and other customary closing conditions and is expected to be completed during the first quarter of 2013.

On October 25, 2012, Sterling declared a quarterly cash dividend of \$0.15 per common share. The dividend is payable on November 20, 2012 to shareholders of record as of November 6, 2012.

Table of Contents

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

This report contains forward-looking statements. For a discussion about such statements, including the risks and uncertainties inherent therein, see "Forward-Looking Statements." Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with the Consolidated Financial Statements and Notes presented elsewhere in this report and in Sterling's 2011 annual report on Form 10-K.

General

Sterling Financial Corporation, with headquarters in Spokane, Washington, was organized under the laws of Washington State in 1992 as the bank holding company for Sterling Savings Bank, which commenced operations in 1983. References to "Sterling," "the Company," "we," "our," or "us" in this report are 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 Bank" refer to our subsidiary Sterling Savings Bank, a Washington state-chartered commercial bank that operates under the registered trade names of Sterling Bank and Sonoma Bank. Sterling Bank operates as Sonoma Bank only in the state of California. Sterling Bank offers retail and commercial banking products and services, mortgage lending and wealth management to individuals, small businesses, commercial organizations and corporations. As of September 30, 2012, Sterling had assets of \$9.47 billion and operated 183 depository branches in Washington, Oregon, Idaho, Montana, and California.

Overview

Net income for the three and nine months ended September 30, 2012 was \$30.6 million and \$364.8 million, respectively, compared with \$11.3 million and \$24.3 million respectively for the three and nine months ended September 30, 2011. Net income during the second quarter of 2012 included an income tax benefit of \$288.8 million associated with the release of the deferred tax asset valuation allowance. The increase in income before income taxes over the periods presented includes an increase in mortgage banking income, lower credit costs from an improvement in asset quality, and an expansion in the net interest margin. During 2012, Sterling has declared two quarterly cash dividends of \$0.15 per share, compared with none being declared in 2011.

Mortgage banking income for the three and nine months ended September 30, 2012 was \$28.5 million and \$69.3 million respectively, an increase of 74% and 85% over the comparable 2011 periods. Net interest margin (tax equivalent) for the three and nine months ended September 30, 2012 expanded by 9 and 17 basis points, respectively, over the comparable 2011 periods. Average loan balances during the three and nine months ended September 30, 2012 increased 8% and 6% over the respective 2011 periods.

On February 29, 2012, Sterling completed the purchase and assumption transaction with First Independent Investment Group, Inc. ("FIG") and its wholly-owned subsidiary, First Independent Bank ("First Independent"). The First Independent transaction added \$350.0 million of loans, \$695.9 million of deposits, and 14 branches in the Vancouver/Portland metro area.

On June 29, 2012, Sterling Bank entered into a definitive agreement for the sale of its Montana operations to Eagle Bancorp Montana, Inc. and its wholly owned subsidiary American Federal Savings Bank. The transaction is subject to customary closing conditions, and is expected to be completed during the fourth quarter of 2012.

On August 14, 2012, the United States Department of the Treasury ("Treasury") sold all of its shares in Sterling common stock in an underwritten public offering. On September 19, 2012, Sterling repurchased a warrant for 97,541 shares held by Treasury. The warrant and stock investment had been issued to Treasury on December 5, 2008, in

connection with Sterling's participation in the Capital Purchase Program of the Troubled Asset Relief Program.

On October 22, 2012, Sterling entered into a definitive agreement with American Heritage Holdings ("AHH"), the holding company for Borrego Springs Bank, N.A., to acquire AHH for cash consideration of \$6.5 million. The transaction, which has been approved by the boards of directors of Sterling and AHH, is expected to provide a significant enhancement to Sterling's small business government guaranteed lending and servicing capabilities. The shareholders of AHH have agreed to vote in favor of the transaction, which is subject to regulatory approval and other customary closing conditions and is expected to be completed during the first quarter of 2013.

Table of Contents

Selected Financial Data

| | Three Months Ended | | Nine Months Ended | | |
|---|--------------------|--------------------|-------------------|------------|---|
| | September 30, | | September 30, | | |
| | 2012 | 2011 | 2012 | 2011 | |
| Basic earnings per share | \$0.49 | \$0.18 | \$5.87 | (2) \$0.39 | |
| Diluted earnings per share | 0.49 | 0.18 | 5.81 | (2) 0.39 | |
| Dividends per share | 0.15 | 0.00 | 0.15 | 0.00 | |
| Return on average assets | 1.28 | % 0.49 | % 5.18 | % (2) 0.35 | % |
| Return on average equity | 9.8 | 5.4 | 45.5 | (2) 4.1 | |
| Net interest margin (tax equivalent) | 3.43 | 3.34 | 3.46 | 3.29 | |
| Efficiency ratio (1) | 69.7 | 71.1 | 71.5 | 74.0 | |
| Net charge-offs to average loans (annualized) | 0.37 | 1.99 | 0.66 | 1.96 | |
| | | September 30, 2012 | December 31, 2011 | | |
| Book value per share | | \$20.14 | \$14.16 | | |
| Tangible book value per share | | 19.44 | 13.96 | | |
| Market value per share | | 22.27 | 16.70 | | |
| Tier one leverage ratio (consolidated) | | 12.7 | % 11.4 | % | |
| Loan loss allowance to total loans | | 2.51 | 3.22 | | |
| Nonperforming assets to total assets | | 2.73 | 4.01 | | |

(1) The efficiency ratio is noninterest expense, excluding OREO and amortization of core deposit intangibles, divided by net interest income (tax equivalent) plus noninterest income, excluding gain on sales of securities, other-than-temporary impairment losses on securities and charge on prepayment of debt.

(2) Includes an income tax benefit of \$288.8 million associated with the release of a deferred tax asset valuation allowance.

Results of Operations

The most significant component of earnings for Sterling is net interest income, which is the difference between interest income, earned primarily from loans, MBS and investment securities, and interest expense on deposits and borrowings. Net interest spread refers to the difference between the yield on interest earning assets and the rate paid on interest bearing liabilities. Net interest margin refers to net interest income divided by total average interest earning assets and is influenced by the level and relative mix of interest earning assets and interest bearing liabilities. The following table sets forth, on a tax equivalent basis, information with regard to Sterling's net interest income, net interest spread and net interest margin:

Table of Contents

| | Three Months Ended September 30, 2012 | | | September 30, 2011 | | | | |
|---|--|--------------------------------|------------------|--------------------|--------------------------------|------------------|------|---|
| | Average Balance | Interest Income/ Expense | Yields/ Rates | Average Balance | Interest Income/ Expense | Yields/ Rates | | |
| (in thousands) | | | | | | | | |
| ASSETS: | | | | | | | | |
| Loans: | | | | | | | | |
| Mortgage | \$3,863,670 | \$47,757 | 4.94 | % | \$3,470,241 | \$45,843 | 5.24 | % |
| Commercial and consumer | 2,583,756 | 35,479 | 5.46 | % | 2,483,204 | 36,282 | 5.80 | % |
| Total loans ⁽¹⁾ | 6,447,426 | 83,236 | 5.15 | % | 5,953,445 | 82,125 | 5.47 | % |
| MBS ⁽²⁾ | 1,762,950 | 10,361 | 2.35 | % | 2,193,055 | 16,719 | 3.02 | % |
| Investments and cash ⁽²⁾ | 529,407 | 3,392 | 2.55 | % | 767,714 | 3,596 | 1.86 | % |
| FHLB stock | 99,160 | 0 | 0.00 | % | 99,395 | 0 | 0.00 | % |
| Total interest earning assets | 8,838,943 | 96,989 | 4.38 | % | 9,013,609 | 102,440 | 4.51 | % |
| Noninterest earning assets ⁽³⁾ | 681,587 | | | | 219,503 | | | |
| Total average assets | \$9,520,530 | | | | \$9,233,112 | | | |
| LIABILITIES and EQUITY: | | | | | | | | |
| Deposits: | | | | | | | | |
| Interest bearing transaction | \$684,906 | 73 | 0.04 | % | \$501,884 | 123 | 0.10 | % |
| Savings and MMDA | 2,284,749 | 884 | 0.15 | % | 1,970,823 | 1,601 | 0.32 | % |
| Time deposits | 2,168,056 | 8,024 | 1.47 | % | 2,952,566 | 12,411 | 1.67 | % |
| Total interest bearing deposits | 5,137,711 | 8,981 | 0.70 | % | 5,425,273 | 14,135 | 1.03 | % |
| Borrowings | 1,358,348 | 11,702 | 3.43 | % | 1,710,388 | 12,408 | 2.88 | % |
| Total interest bearing liabilities | 6,496,059 | 20,683 | 1.27 | % | 7,135,661 | 26,543 | 1.48 | % |
| Noninterest bearing transaction | 1,656,318 | 0 | 0.00 | % | 1,132,589 | 0 | 0.00 | % |
| Total funding liabilities | 8,152,377 | 20,683 | 1.01 | % | 8,268,250 | 26,543 | 1.27 | % |
| Other noninterest bearing liabilities | 130,948 | | | | 132,625 | | | |
| Total average liabilities | 8,283,325 | | | | 8,400,875 | | | |
| Total average equity | 1,237,205 | | | | 832,237 | | | |
| Total average liabilities and equity | \$9,520,530 | | | | \$9,233,112 | | | |
| Net interest income and spread ⁽⁴⁾ | | \$76,306 | 3.11 | % | | \$75,897 | 3.03 | % |
| Net interest margin ⁽⁴⁾ | | | 3.43 | % | | | 3.34 | % |
| Deposits: | | | | | | | | |
| Total interest bearing deposits | \$5,137,711 | \$8,981 | 0.70 | % | \$5,425,273 | \$14,135 | 1.03 | % |
| Noninterest bearing transaction | 1,656,318 | 0 | 0.00 | % | 1,132,589 | 0 | 0.00 | % |
| Total deposits | \$6,794,029 | \$8,981 | 0.53 | % | \$6,557,862 | \$14,135 | 0.86 | % |

(1) Includes gross nonaccrual loans.

(2) Does not include market value adjustments on available for sale securities.

(3) Includes charge-offs on nonperforming loans ("confirmed losses") and the allowance for loan losses.

(4) Interest income on certain loans and securities are presented gross of their applicable tax savings using a 37% effective tax rate.

Table of Contents

| | Nine Months Ended September 30, 2012 | | | September 30, 2011 | | | Yields/ Rates | |
|---|---|--------------------------------|------------------|--------------------|--------------------------------|------------------|------------------|---|
| | Average Balance | Interest Income/ Expense | Yields/ Rates | Average Balance | Interest Income/ Expense | Yields/ Rates | | |
| (in thousands) | | | | | | | | |
| ASSETS: | | | | | | | | |
| Loans: | | | | | | | | |
| Mortgage | \$3,757,341 | \$141,306 | 5.01 | % | \$3,472,494 | \$132,731 | 5.11 | % |
| Commercial and consumer | 2,555,147 | 107,504 | 5.62 | % | 2,494,194 | 109,749 | 5.88 | % |
| Total loans ⁽¹⁾ | 6,312,488 | 248,810 | 5.26 | % | 5,966,688 | 242,480 | 5.43 | % |
| MBS ⁽²⁾ | 1,989,989 | 38,632 | 2.59 | % | 2,409,804 | 56,681 | 3.14 | % |
| Investments and cash ⁽²⁾ | 553,827 | 10,634 | 2.56 | % | 742,983 | 11,228 | 2.02 | % |
| FHLB stock | 99,148 | 0 | 0.00 | % | 99,657 | 0 | 0.00 | % |
| Total interest earning assets | 8,955,452 | 298,076 | 4.44 | % | 9,219,132 | 310,389 | 4.50 | % |
| Noninterest earning assets ⁽³⁾ | 442,691 | | | | 137,355 | | | |
| Total average assets | \$9,398,143 | | | | \$9,356,487 | | | |
| LIABILITIES and EQUITY: | | | | | | | | |
| Deposits: | | | | | | | | |
| Interest bearing transaction | \$637,106 | 271 | 0.06 | % | \$499,310 | 397 | 0.11 | % |
| Savings and MMDA | 2,252,052 | 3,101 | 0.18 | % | 1,970,654 | 5,311 | 0.36 | % |
| Time deposits | 2,369,682 | 26,632 | 1.50 | % | 3,191,041 | 40,937 | 1.72 | % |
| Total interest bearing deposits | 5,258,840 | 30,004 | 0.76 | % | 5,661,005 | 46,645 | 1.10 | % |
| Borrowings | 1,489,663 | 36,371 | 3.26 | % | 1,703,027 | 36,932 | 2.90 | % |
| Total interest bearing liabilities | 6,748,503 | 66,375 | 1.31 | % | 7,364,032 | 83,577 | 1.52 | % |
| Noninterest bearing transaction | 1,498,471 | 0 | 0.00 | % | 1,059,759 | 0 | 0.00 | % |
| Total funding liabilities | 8,246,974 | 66,375 | 1.08 | % | 8,423,791 | 83,577 | 1.33 | % |
| Other noninterest bearing liabilities | 80,176 | | | | 130,620 | | | |
| Total average liabilities | 8,327,150 | | | | 8,554,411 | | | |
| Total average equity | 1,070,993 | | | | 802,076 | | | |
| Total average liabilities and equity | \$9,398,143 | | | | \$9,356,487 | | | |
| Net interest income and spread ⁽⁴⁾ | | \$231,701 | 3.13 | % | | \$226,812 | 2.98 | % |
| Net interest margin ⁽⁴⁾ | | | 3.46 | % | | | 3.29 | % |
| Deposits: | | | | | | | | |
| Total interest bearing deposits | \$5,258,840 | \$30,004 | 0.76 | % | \$5,661,005 | \$46,645 | 1.10 | % |
| Noninterest bearing transaction | 1,498,471 | 0 | 0.00 | % | 1,059,759 | 0 | 0.00 | % |
| Total deposits | \$6,757,311 | \$30,004 | 0.59 | % | \$6,720,764 | \$46,645 | 0.93 | % |

(1) Includes gross nonaccrual loans.

(2) Does not include market value adjustments on available for sale securities.

(3) Includes charge-offs on nonperforming loans ("confirmed losses") and the allowance for loan losses.

(4) Interest income on certain loans and securities are presented gross of their applicable tax savings using a 37% effective tax rate.

Table of Contents

Net Interest Income. Sterling's net interest income for the three months ended September 30, 2012 compared with the three months ended September 30, 2011 increased \$472,000, with a decline in deposit costs mostly offset by a decline in income on MBS. The decline in deposit funding costs reflected the increase in lower cost transaction accounts, combined with a reduction in higher costing time deposits. Average total transaction account balances during the three and nine months ended September 30, 2012 increased by 43% and 37% over their respective 2011 periods. Average MBS balances declined 20% for the three months ended September 30, 2012 compared with the three months ended September 30, 2011, while the yield declined from 3.02% to 2.35%. This decline in average balance and yield reflected market conditions and balance sheet management, including the management of prepayment and interest rate risk in the MBS portfolio.

Average loan balances grew 8% during the three months ended September 30, 2012 compared with the three months ended September 30, 2011, reflecting growth from loan originations and purchases, and loans acquired in the First Independent transaction. The increase in interest income from higher average loan balances was partially offset by yield compression. Yields on new loans were at lower levels compared with yields on maturing loans, and adjustable rate loans repriced downward. These reductions in yield were partially offset by the decline in the level of nonperforming loans and discount accretion on acquired loans.

Net interest income for the nine months ended September 30, 2012 was \$228.6 million, an increase of \$5.2 million or 2% compared with the nine months ended September 30, 2011. Similar to the quarterly comparison, a decline in deposit costs was partially offset by a decline in income on MBS, and the increase in interest income from higher average loan balances was offset by yield compression.

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

Sterling recorded a provision for credit losses of \$2.0 million and \$10.0 million for the three and nine months ended September 30, 2012, as compared with \$6.0 million and \$26.0 million, respectively, in the comparative 2011 periods. The reduced level of credit loss provisioning reflects improvement in asset quality as evidenced by the decline in nonperforming loans and charge-offs. Total net charge-offs of \$35.4 million during the nine months ended September 30, 2012 included approximately \$4 million charged against the allowance for unfunded commitments, in connection with a mortgage repurchase settlement with a financial institution.

Table of Contents

Noninterest Income. Noninterest income was as follows for the periods presented:

| | Three Months Ended September 30, | | | Nine Months Ended September 30, | | |
|--|----------------------------------|----------|----------|---------------------------------|----------|----------|
| | 2012 | 2011 | % Change | 2012 | 2011 | % Change |
| | (in thousands) | | | | | |
| Fees and service charges | \$14,675 | \$12,332 | 19 % | \$41,546 | \$37,839 | 10 % |
| Mortgage banking operations | 28,502 | 16,360 | 74 % | 69,318 | 37,481 | 85 % |
| Loan servicing fees | (2,092) | (4,694) | (55)% | (183) | (2,884) | (94)% |
| BOLI | 1,660 | 1,612 | 3 % | 7,175 | 4,922 | 46 % |
| Gains on sales of securities, net | 3,129 | 0 | * | 12,592 | 14,298 | (12)% |
| Other-than-temporary impairment losses on securities | 0 | 0 | * | (6,819) | 0 | * |
| Charge on prepayment of debt | 0 | 0 | * | (2,664) | 0 | * |
| Gains on other loan sales | 476 | 2,671 | (82)% | 3,887 | 1,792 | 117 % |
| Other | 348 | 831 | (58)% | (1,826) | (19) | 9,511 % |
| Total noninterest income | \$46,698 | \$29,112 | 60 % | \$123,026 | \$93,429 | 32 % |

* Results are not meaningful.

The growth in fees and service charges was primarily due to increased activity related to the addition of the First Independent accounts. The increase in income from mortgage banking operations reflected higher margins on loan sales and volumes of residential lending. Historically low interest rates on home loans has resulted in an elevated level of refinancing activity. The fluctuation in loan servicing fees reflects valuation adjustments on mortgage servicing rights. BOLI income for the nine months ended September 30, 2012 included \$2.4 million relating to a death benefit. Gains on sales of securities resulting from portfolio management included the rebalancing of prepayment and interest rate risk in the portfolio. During the second quarter of 2012, Sterling recognized an other-than-temporary impairment charge of \$6.8 million related to a single issuer trust preferred security and a \$2.7 million charge related to the prepayment of a \$50.0 million term repurchase agreement with a fixed interest cost of 3.99 percent. Gains on the sale of other loans was primarily related to the sale of nonperforming loans. Other noninterest income for the nine months ended September 30, 2012 included \$1.7 million of branch consolidation costs.

The following table presents components of mortgage banking operations for the periods presented:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|----------------------------------|-----------|---------------------------------|-------------|
| | 2012 | 2011 | 2012 | 2011 |
| | (in thousands) | | | |
| Residential loan sales | \$728,642 | \$475,034 | \$1,869,213 | \$1,371,465 |
| Change in warehouse and interest rate locks | 36,018 | 123,859 | 348,600 | 99,009 |
| Total mortgage banking activity | \$764,660 | \$598,893 | \$2,217,813 | \$1,470,474 |
| Margin on residential loan sales | 3.68 | % 2.66 | % 3.07 | % 2.46 |

Expansion in the margin on loans sales over the periods presented reflect conditions in the mortgage market, including the affects from the Federal Reserve's monetary policy.

Table of Contents

Noninterest Expense. Noninterest expense was as follows for the periods presented:

| | Three Months Ended September 30, | | | Nine Months Ended September 30, | | |
|---|----------------------------------|----------|----------|---------------------------------|-----------|----------|
| | 2012 | 2011 | % change | 2012 | 2011 | % change |
| | (in thousands) | | | | | |
| Employee compensation and benefits | \$45,636 | \$43,828 | 4 % | \$139,502 | \$129,514 | 8 % |
| OREO operations | 4,008 | 10,739 | (63)% | 9,337 | 36,591 | (74)% |
| Occupancy and equipment | 11,034 | 9,580 | 15 % | 32,253 | 29,558 | 9 % |
| Data processing | 7,137 | 5,651 | 26 % | 20,600 | 18,339 | 12 % |
| FDIC insurance | 2,159 | 3,510 | (38)% | 6,005 | 10,903 | (45)% |
| Professional fees | 4,929 | 3,161 | 56 % | 12,718 | 9,571 | 33 % |
| Depreciation | 2,918 | 3,000 | (3)% | 8,754 | 9,026 | (3)% |
| Advertising | 3,442 | 1,932 | 78 % | 10,370 | 6,659 | 56 % |
| Travel and entertainment | 1,420 | 1,336 | 6 % | 4,019 | 3,931 | 2 % |
| Merger and acquisition | 1,584 | 0 | * | 9,981 | 0 | * |
| Amortization of other intangible assets | 1,792 | 1,190 | 51 % | 4,988 | 3,639 | 37 % |
| Other | 3,349 | 2,693 | 24 % | 7,137 | 8,784 | (19)% |
| Total noninterest expense | \$89,408 | \$86,620 | 3 % | \$265,664 | \$266,515 | 0 % |

* Results are not meaningful.

Employee compensation and benefits during 2012 included severance costs related to a reduction in force, an increase in commissions due to growth in mortgage banking originations, and growth from the First Independent transaction. The reduction in OREO expenses was related to the decline in nonperforming assets and the stabilization of collateral values. The decline in Federal Deposit Insurance Corporation ("FDIC") insurance expense was due to a lower risk based assessment rate being applicable. Advertising expense during 2012 included costs related to the rebranding of Sterling Savings Bank as Sterling Bank, with no rebranding charges recognized in the comparative periods. Merger and acquisition expense for the 2012 periods reflected costs associated with the First Independent transaction, including system conversion costs, professional fees and employee severance. Other noninterest expense during 2012 included a refund of \$1.9 million for Washington State Business and Occupation tax.

Income Tax Provision. During the three months ended September 30, 2012, Sterling did not recognize any federal or state income tax expense, while during the nine months ended September 30, 2012, Sterling recorded a \$288.8 million income tax benefit, which was the result of reversing substantially all of the deferred tax asset valuation allowance. Sterling did not recognize any federal or state income tax expense during the comparable periods of 2011. As of September 30, 2012, the net deferred tax asset was \$280.4 million, including \$273.0 million of net operating loss and tax credit carry-forwards. As of December 31, 2011, Sterling had a fully reserved net deferred tax asset of \$327.0 million, including \$285.0 million of net operating loss and tax credit carry-forwards.

Financial Position

Assets. At September 30, 2012, Sterling's assets were \$9.47 billion, an increase of \$279.2 million from \$9.19 billion at December 31, 2011, with the growth a result of increases in the loan portfolio, both organic and from the First Independent transaction, and the release of the deferred tax asset valuation allowance.

Investments and MBS. Sterling's investment and MBS portfolio at September 30, 2012 was \$2.05 billion, compared with \$2.55 billion at December 31, 2011. Aggregate cash flows from prepayments, sales and maturities for the nine months ended September 30, 2012 were greater than purchases. On September 30, 2012, the investment and MBS portfolio had an unrealized net gain of \$85.5 million versus \$62.2 million at December 31, 2011.

Table of Contents

Loans Receivable. The following table sets forth the composition of Sterling's loan portfolio by class of loan at the dates indicated:

| | September 30, 2012 | | December 31, 2011 | | |
|---------------------------------|--------------------|-----|-------------------|-----|----|
| | Amount | % | Amount | % | |
| | (in thousands) | | | | |
| Residential real estate | \$818,323 | 13 | \$688,020 | | 13 |
| Commercial real estate ("CRE"): | | | | | |
| Investor CRE | 1,274,774 | 21 | 1,275,667 | | 23 |
| Multifamily | 1,359,506 | 22 | 1,001,479 | | 18 |
| Construction | 99,553 | 2 | 174,608 | | 3 |
| Total CRE | 2,733,833 | 45 | 2,451,754 | | 44 |
| Commercial: | | | | | |
| Owner occupied CRE | 1,304,224 | 21 | 1,272,461 | | 23 |
| Commercial & Industrial ("C&I") | 517,588 | 8 | 431,693 | | 8 |
| Total commercial | 1,821,812 | 29 | 1,704,154 | | 31 |
| Consumer | 768,359 | 13 | 674,961 | | 12 |
| Gross loans receivable | 6,142,327 | 100 | 5,518,889 | 100 | % |
| Deferred loan fees, net | 2,317 | | (252) | |) |
| Allowance for loan losses | (154,279) |) | (177,458) |) | |
| Loans receivable, net | \$5,990,365 | | \$5,341,179 | | |

During the first quarter of 2012, net loans acquired in the First Independent transaction were \$350.0 million. During the nine months ended September 30, 2012, Sterling originated \$1.26 billion of loans for its portfolio, compared to \$1.04 billion for the nine months ended September 30, 2011. Loan originations and purchases outpaced reductions as a result of principal repayments during the nine months ended September 30, 2012. Sterling continues to monitor the portfolio and actively manage concentrations.

Table of Contents

The following table sets forth Sterling's loan originations and purchases for the periods indicated, which are in addition to the amounts acquired upon completion of the First Independent transaction:

| | Three Months Ended | | Nine Months Ended | |
|---|-----------------------|-----------------------|-----------------------|-----------------------|
| | September 30, 2012 | September 30, 2011 | September 30, 2012 | September 30, 2011 |
| | (in thousands) | | | |
| Loan originations: | | | | |
| Residential real estate: | | | | |
| For sale | \$842,197 | \$545,278 | \$1,997,491 | \$1,365,519 |
| Permanent | 77,650 | 14,893 | 152,947 | 65,834 |
| Total residential real estate | 919,847 | 560,171 | 2,150,438 | 1,431,353 |
| CRE: | | | | |
| Investor CRE | 14,889 | 310 | 37,535 | 41,676 |
| Multifamily | 144,560 | 203,606 | 552,241 | 540,591 |
| Construction | 776 | 3,223 | 2,444 | 13,105 |
| Total CRE | 160,225 | 207,139 | 592,220 | 595,372 |
| Commercial: | | | | |
| Owner occupied CRE | 53,541 | 42,360 | 111,833 | 116,707 |
| C&I | 102,255 | 54,446 | 206,310 | 163,723 |
| Total commercial | 155,796 | 96,806 | 318,143 | 280,430 |
| Consumer | 63,435 | 29,513 | 199,881 | 97,888 |
| Total loan originations | 1,299,303 | 893,629 | 3,260,682 | 2,405,043 |
| Total portfolio loan originations (excludes residential real estate for sale) | 457,106 | 348,351 | 1,263,191 | 1,039,524 |
| Loan purchases: | | | | |
| Residential real estate | 1,646 | 2,701 | 76,408 | 10,251 |
| CRE: | | | | |
| Investor CRE | 0 | 0 | 0 | 48,584 |
| Multifamily | 292 | 309 | 683 | 2,749 |
| Total CRE | 292 | 309 | 683 | 51,333 |
| Commercial: | | | | |
| Owner occupied CRE | 0 | 22,495 | 0 | 74,716 |
| C&I | 0 | 0 | 0 | 0 |
| Total commercial | 0 | 22,495 | 0 | 74,716 |
| Consumer | 41,567 | 0 | 52,307 | 0 |
| Total loan purchases | 43,505 | 25,505 | 129,398 | 136,300 |
| Total loan originations and purchases | \$1,342,808 | \$919,134 | \$3,390,080 | \$2,541,343 |

The increase in residential, C&I and consumer originations and purchases reflect customer demand and Sterling's focus on growing these segments. Residential loan purchases during 2012 were comprised primarily of adjustable rate mortgages. Consumer loan purchases were comprised of fixed rate auto loans. The loan purchases offered favorable yields compared to MBS.

Table of Contents

The following table presents a roll-forward of the allowance for credit losses for the periods presented:

| | Three Months Ended September 30, 2012 | | Nine Months Ended September 30, 2012 | |
|---|---|------------|--|------------|
| | 2011 | 2011 | 2011 | 2011 |
| | (in thousands) | | | |
| Allowance for credit losses | | | | |
| Allowance - loans, beginning balance | \$ 158,244 | \$ 212,088 | \$ 177,458 | \$ 247,056 |
| Provision | 2,000 | 4,000 | 8,000 | 26,500 |
| Charge-offs | (10,479) | (41,177) | (51,056) | (109,903) |
| Recoveries | 4,514 | 11,284 | 19,877 | 22,542 |
| Allowance - loans, ending balance | 154,279 | 186,195 | 154,279 | 186,195 |
| Allowance - unfunded commitments, beginning balance | 7,952 | 7,431 | 10,029 | 10,707 |
| Provision | 0 | 2,000 | 2,000 | (500) |
| Charge-offs | (181) | (55) | (4,258) | (831) |
| Allowance - unfunded commitments, ending balance | 7,771 | 9,376 | 7,771 | 9,376 |
| Total credit allowance | \$ 162,050 | \$ 195,571 | \$ 162,050 | \$ 195,571 |

See Note 4 of the Notes to Consolidated Financial Statements for further details by loan segment for changes in the allowance for credit losses. The decline in the allowance for credit losses from September 30, 2011 reflects a reduction in the level of classified loans. The following table presents classified assets, which are comprised of loans risk rated as substandard, doubtful or loss, and OREO.

| | September 30, 2012 (in thousands) | December 31, 2011 | |
|---------------------------------|--------------------------------------|-------------------|---|
| Residential real estate | \$ 25,917 | \$ 30,918 | |
| CRE: | | | |
| Investor CRE | 67,349 | 75,304 | |
| Multifamily | 11,003 | 15,995 | |
| Construction | 23,945 | 98,773 | |
| Total CRE | 102,297 | 190,072 | |
| Commercial: | | | |
| Owner occupied CRE | 72,915 | 94,660 | |
| C&I | 12,206 | 21,029 | |
| Total commercial | 85,121 | 115,689 | |
| Consumer | 7,559 | 7,157 | |
| Total classified loans | 220,894 | 343,836 | |
| OREO | 46,575 | 81,910 | |
| Total classified assets | \$ 267,469 | \$ 425,746 | |
| Classified loans/ total loans | 3.6 | % 6.2 | % |
| Classified assets/ total assets | 2.8 | % 4.6 | % |

Table of Contents

Classified assets declined \$158.3 million, or 37% during the nine months ended September 30, 2012. Nonperforming assets include nonperforming loans and OREO, are summarized in the following table as of the dates indicated:

| | September 30, 2012 | December 31, 2011 | |
|--|-----------------------|----------------------|------|
| | (in thousands) | | |
| Past due 90 days or more and accruing | \$0 | \$0 | |
| Nonaccrual loans | 146,095 | 210,221 | |
| Restructured loans | 66,343 | 76,939 | |
| Total nonperforming loans | 212,438 | 287,160 | |
| OREO | 46,575 | 81,910 | |
| Total nonperforming assets | 259,013 | 369,070 | |
| Specific reserve - loans | (10,104 |) (16,305 |) |
| Net nonperforming assets | \$248,909 | \$352,765 | |
| Nonperforming assets to total assets | 2.73 | % | 4.01 |
| Nonperforming loans to loans | 3.46 | % | 5.20 |
| Loan loss allowance to nonperforming loans | 73 | % | 62 |

Nonperforming assets declined 30% during the nine months ended September 30, 2012, as a result of OREO sales and other asset resolution efforts outpacing new problem loans. The following table presents a roll-forward of nonperforming loans for the periods indicated:

| | Three Months Ended September 30, 2012 | | 2011 | | Nine Months Ended September 30, 2012 | | 2011 | |
|----------------------|--|---|-----------|---|---|---|-----------|---|
| | (in thousands) | | | | | | | |
| Nonperforming loans: | | | | | | | | |
| Beginning Balance | \$265,340 | | \$396,109 | | \$287,160 | | \$654,637 | |
| Additions | 29,957 | | 66,613 | | 129,488 | | 178,725 | |
| Charge-offs | (5,965 |) | (29,893 |) | (31,179 |) | (87,361 |) |
| Paydowns and sales | (58,967 |) | (42,379 |) | (106,981 |) | (163,440 |) |
| Foreclosures | (7,979 |) | (60,483 |) | (30,503 |) | (161,671 |) |
| Upgrade to accrual | (9,948 |) | (6,828 |) | (35,547 |) | (97,751 |) |
| Ending Balance | \$212,438 | | \$323,139 | | \$212,438 | | \$323,139 | |

The following table presents a roll-forward of OREO for the periods indicated:

| | Three Months Ended September 30, 2012 | | | | 2011 | | | | Nine Months Ended September 30, 2012 | | | | 2011 | | | |
|-----------------------|--|------------|-----------|------------|-----------|------------|------------|------------|---|------------|--------|------------|--------|------------|--|--|
| | Amount | Properties | Amount | Properties | Amount | Properties | Amount | Properties | Amount | Properties | Amount | Properties | Amount | Properties | | |
| OREO: | (Dollars in thousands) | | | | | | | | | | | | | | | |
| Beginning Balance | \$55,801 | 81 | \$101,406 | 250 | \$81,910 | 143 | \$161,653 | 439 | | | | | | | | |
| Additions | 8,131 | 28 | 60,483 | 91 | 30,661 | 97 | 161,671 | 389 | | | | | | | | |
| Valuation adjustments | (1,656 |) | (7,995 |) | (5,028 |) | (20,850 |) | | | | | | | | |
| Sales | (15,666 |) (39 |) (40,845 |) (163 |) (62,202 |) (170 |) (194,081 |) (650 | | | | | | | | |
| Other changes | (35 |) | (1,483 |) | 1,234 | | 3,173 | | | | | | | | | |
| Ending Balance | \$46,575 | 70 | \$111,566 | 178 | \$46,575 | 70 | \$111,566 | 178 | | | | | | | | |

Table of Contents

OREO declined 58% compared with September 30, 2011. The following table presents the property type composition of OREO as of the following dates:

| | September 30, 2012 | | December 31, 2011 | |
|-------------------------|------------------------|----------------------|-------------------|----------------------|
| | Amount | Number of Properties | Amount | Number of Properties |
| OREO: | (Dollars in thousands) | | | |
| Residential real estate | \$ 1,582 | 12 | \$ 5,301 | 50 |
| CRE: | | | | |
| Investor CRE | 5,149 | 10 | 14,685 | 19 |
| Multifamily | 0 | 0 | 0 | 0 |
| Construction | 29,504 | 19 | 52,829 | 48 |
| Commercial: | | | | |
| Owner occupied CRE | 8,013 | 24 | 5,424 | 17 |
| C&I | 2,162 | 2 | 2,196 | 2 |
| Consumer | 165 | 3 | 1,475 | 7 |
| Ending Balance | \$ 46,575 | 70 | \$ 81,910 | 143 |

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

| | September 30, 2012 | | December 31, 2011 | | |
|---------------------------------|--------------------|-----|-------------------|-----|---|
| | Amount | % | Amount | % | |
| | (in thousands) | | | | |
| Noninterest bearing transaction | \$ 1,709,612 | 25 | % \$ 1,211,628 | 19 | % |
| Interest bearing transaction | 693,906 | 10 | % 521,037 | 8 | % |
| Savings and MMDA | 2,286,832 | 35 | % 2,092,283 | 32 | % |
| Time deposits | 2,049,560 | 30 | % 2,660,870 | 41 | % |
| Total deposits | \$ 6,739,910 | 100 | % \$ 6,485,818 | 100 | % |

The increase in total deposits from December 31, 2011, was primarily a result of the First Independent transaction, which contributed \$695.9 million of new deposits. As of September 30, 2012, transaction account balances had increased to 35% of total deposits, compared with 27% as of December 31, 2011. The decline in time deposits was primarily a result of expected runoff.

Borrowings. In addition to deposits, Sterling uses other borrowings as sources of funds. The aggregate amount of other borrowings outstanding comprised of FHLB advances, reverse repurchase agreements and junior subordinated debentures, was \$1.34 billion as of September 30, 2012 compared with \$1.71 billion at December 31, 2011, respectively. The decline reflects the maturity or prepayment of FHLB advances and repurchase agreements. Included in borrowings as of September 30, 2012 were structured reverse repurchase agreements of \$900.0 million at an average cost of 3.88%. As of December 31, 2011, Sterling had structured reverse repurchase agreements outstanding of \$1.00 billion at an average cost of 3.89%.

Asset and Liability Management

The principal objective of Sterling's asset and liability management activities is to provide optimum levels of net interest income and stable sources of funding while maintaining acceptable levels of interest-rate risk and liquidity risk. The Asset/Liability Committee ("ALCO") measures interest rate risk exposure primarily through interest rate shock simulations for both net interest income and the economic value of equity ("EVE"). Interest rate risk arises from mismatches in assets and liabilities, with mismatches due to differences in the timing of rate repricing for the various instruments, the amount or volume of the underlying assets and liabilities that are repricing, and by how much or the

level at which the rate is repricing. The specific characteristics of the underlying assets and liabilities, including any embedded optionality, such as a prepayment option on a loan, influence these differences.

Table of Contents

The net interest income interest rate shock simulation measures the effect of changes in interest rates on net interest income over 12 months. This simulation consists of measuring the change in net interest income over the next 12 months from the base case scenario, from which rates are shocked, in a parallel fashion, up and down. The base case uses the assumption of the existing balance sheet and existing interest rates. The simulation requires numerous assumptions, including relative levels of market interest rates, instantaneous and parallel shifts in the yield curve, loan prepayments and reactions of depositors to changes in interest rates, and should not be relied upon as being indicative of actual or future results. The analysis does not contemplate actions Sterling may undertake in response to changes in interest rates and market conditions. The results of this simulation are included in the following table for the periods presented:

| Change in Interest Rate in Basis Points (Rate Shock) | September 30, | December 31, |
|---|--------------------|--------------------|
| | 2012 | 2011 |
| | % Change in NII | % Change in NII |
| +300 | 4.4 | (4.6) |
| +200 | 0.6 | (2.3) |
| +100 | 0.5 | (0.7) |
| Static | 0.0 | 0.0 |
| -100 | * | * |

* Results are not meaningful in a low interest rate environment.

EVE simulation analysis measures risk in the balance sheet that might not be taken into account in the net interest income simulation. Whereas net interest income simulation highlights exposure over a relatively short time period of 12 months, EVE simulation analysis incorporates all cash flows over the estimated remaining life of all balance sheet positions. The EVE simulation analysis of the balance sheet, at a point in time, is defined as the discounted present value of asset cash flows minus the discounted value of liability cash flows. The difference between the present value of the asset and liability represents the EVE. As with net interest income, the base case simulation uses current market rates, from which rates are shocked up and down in a parallel fashion. As with the net interest income simulation model, EVE simulation analysis is based on key assumptions about the timing and variability of balance sheet cash flows. However, because the simulation represents much longer time periods, inaccuracy of assumptions may increase the variability of outcomes within the simulation. It also does not take into account actions management may undertake in response to anticipated changes in interest rates. The results of this simulation are included in the following table for the periods presented:

| Change in Interest Rate in Basis Points (Rate Shock) | September 30, | December 31, |
|---|--------------------|--------------------|
| | 2012 | 2011 |
| | % Change in EVE | % Change in EVE |
| +300 | 21.3 | 6.2 |
| +200 | 18.7 | 8.9 |
| +100 | 11.6 | 7.0 |
| Static | 0.0 | 0.0 |
| -100 | * | * |

* Results are not meaningful in a low interest rate environment.

Sterling's modeled interest rate sensitivities during the nine months ended September 30, 2012 were affected by changes to its balance sheet, including a reduction in the size and duration of the securities portfolio, and a reduction

in wholesale borrowings. Growth of core deposits and loans, both organic and through acquisition, also positively impacted the modeled results.

Sterling has customer-related interest rate swap derivatives outstanding, with a total notional amount of \$83.2 million of related swaps outstanding as of September 30, 2012. For a description, see Note 11 of Notes to Consolidated Financial Statements. As of September 30, 2012, Sterling has not entered into any other derivative transactions as part of managing its interest rate risk. However, Sterling continues to consider derivatives, including interest rate swaps, caps and floors as viable alternatives in the asset and liability management process.

Table of Contents

Capital and Liquidity Management

Sterling's primary sources of funds are: retail, public and brokered deposits; the collection of principal and interest from loans and MBS; the sale of loans into the secondary market in connection with Sterling's mortgage banking and other loan sale activities; borrowings from the FHLB and the Federal Reserve; and borrowings from commercial banks (including reverse repurchase agreements). Public deposits from states, municipalities, and other public entities generally require collateralization for some or all of the deposit amounts, depending on state and local requirements. Reverse repurchase agreements allow Sterling to sell investments (generally U.S. agency securities and MBS) under an agreement to buy them back at a specified price at a later date. Reverse repurchase agreements are considered collateralized obligations and may expose Sterling to certain risks not associated with other borrowings, including interest rate risk and the possibility that additional collateral may have to be provided if the market value of the pledged collateral declines. Sterling Bank's credit line with FHLB of Seattle provides for borrowings up to a percentage of its total assets, subject to collateralization requirements, with borrowing terms ranging from overnight to term advances. Sterling Bank actively manages its liquidity to maintain an adequate margin over the level necessary to support the funding of loans and deposit withdrawals. Liquidity may vary from time to time, depending on economic conditions, deposit fluctuations, loan funding needs and regulatory requirements.

The total value of Sterling's consolidated cash and equivalents and securities was \$2.32 billion at September 30, 2012, compared with \$3.04 billion at December 31, 2011. Total available liquidity as of September 30, 2012 was \$3.48 billion, compared to \$3.39 billion as of December 31, 2011. Total available liquidity as of September 30, 2012 included unpledged portions of cash and equivalents and securities of \$661.1 million, available borrowing capacity from the FHLB, the Federal Reserve and correspondent banks of \$2.50 billion, as well as loans held for sale of \$320.8 million.

Sterling, as a parent company-only, had cash of approximately \$20.6 million and \$44.6 million at September 30, 2012 and December 31, 2011, respectively. The parent company's significant cash flows primarily relate to capital investments in and capital distributions from Sterling Bank, capital distributions to shareholders, and interest payments on junior subordinated debentures. During the third quarter of 2009, Sterling elected to defer regularly scheduled interest payments on its junior subordinated debentures. In June 2012, the deferred accrued interest on the junior subordinated debentures in the amount of \$19.6 million was paid in full. On August 20, 2012, Sterling paid a quarterly cash dividend of \$0.15 per common share, or an aggregate \$9.3 million, to shareholders of record as of August 6, 2012. On October 25, 2012, Sterling declared a quarterly cash dividend of \$0.15 per common share. The dividend is payable on November 20, 2012 to shareholders of record as of November 6, 2012. Sterling's ability to pay dividends is generally limited by its earnings, financial condition, capital, liquidity and regulatory requirements. Sterling relies on Sterling Bank as its primary source of cash flow. Various federal and state statutory provisions and regulations limit the amount of dividends, if any, Sterling Bank may pay to Sterling without regulatory approval.

Critical Accounting Policies

Sterling's accounting and reporting policies conform to accounting principles generally accepted in the United States of America ("GAAP") and to general practices within the banking industry. The preparation of the financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Allowance for Credit Losses. The allowance for credit losses is comprised of the allowance for loan losses and the reserve for unfunded credit commitments. In general, determining the amount of the allowance requires significant judgment and the use of estimates by management. Sterling maintains an allowance for loan losses to absorb probable losses in the loan portfolio based on a quarterly analysis of the portfolio and expected losses. This analysis is designed

to determine an appropriate level and allocation of the allowance for losses among loan classes by considering factors affecting loan losses, including specific and confirmed losses, levels and trends in classified and nonperforming loans, historical loan loss experience, loan migration analysis, current national and local economic conditions, volume, growth and composition of the portfolio, regulatory guidance and other relevant factors. The reserve for unfunded credit commitments includes loss coverage for loan repurchases arising from mortgage banking activities.

Management monitors the loan portfolio to evaluate the adequacy of the allowance. The allowance can increase or decrease each quarter based upon the results of management's analysis.

The portfolio is grouped into several industry segments for homogeneous loans based on characteristics such as loan type, borrower and collateral. Loan migration to loss data is used to determine the annual probability of default. The annual probability of default is adjusted for the estimated loss emergence period and may be further adjusted based on the assessment of qualitative factors. The estimated loss emergence period reflects an estimate of the time frame during which losses may be

Table of Contents

realized. Currently, Sterling is establishing the expected loss rate on loans using the losses on charged-off and foreclosed loans from the most recent 12 months 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 class.

Sterling may also maintain an unallocated allowance to provide for other credit losses that may exist in the loan portfolio that are not taken into consideration in establishing the probability of default and loss given default. The unallocated amount may generally be maintained at higher levels during times of economic uncertainty. The unallocated amount is reviewed at least quarterly based on credit and economic trends.

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

A loan is considered impaired when, based on current information and events, it is probable Sterling will be unable to collect the scheduled payments of principal and interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of delay, the reasons for the delay, the borrower's prior payment record, the ability and willingness of guarantors to make payments, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan-by-loan basis by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price or the fair value of collateral if the loan is collateral-dependent.

The fair value of the underlying collateral for real estate loans, which may or may not be collateral-dependent, is determined by using appraisals from qualified external sources. For commercial properties and residential development loans, the external appraisals are reviewed by qualified internal appraisal staff to ensure compliance with appropriate standards and technical accuracy. Appraisals are updated according to regulatory provisions for extensions or restructurings of commercial or residential real estate construction and permanent loans that have not performed within the terms of the original loan. Updated appraisals are also ordered for loans that have not been restructured, but that have stale valuation information, generally defined in the current market as information older than one year, and deteriorating credit quality that warrants classification as substandard.

The timing of obtaining appraisals may vary, depending on the nature and complexity of the property being evaluated and the general breadth of appraisal activity in the marketplace, but generally it is within 30 to 90 days of recognition of substandard status, following determination of collateral dependency, or in connection with a loan's maturity or a negotiation that may result in the restructuring or extension of a real estate secured loan. Delays in timing may occur to comply with actions such as a bankruptcy filing or provisions of an SBA guarantee.

Estimates of fair value may be used for substandard collateral-dependent loans at quarter end if external appraisals are not expected to be completed in time for determining quarter end results or to update values between appraisal dates to reflect recent sales activity of comparable inventory or pending property sales of the subject collateral. During periods of declining real estate values, Sterling may record a specific reserve for impaired loans for which an updated valuation analysis has not been completed within the last quarter. The specific reserve is calculated by applying an estimated fair value adjustment to each loan based on market and property type. Estimates of value are not used to raise a value; however, estimates may be used to recognize deterioration of market values in quarters between appraisal updates. The judgment with respect to recognition of any provision or related charge-off for a confirmed loss also takes into consideration whether the loan is collateral-dependent or whether it is supported by sources of repayment or cash flow beyond the collateral that is being valued. For loans that are deemed to be collateral-dependent, the amount of charge-offs is determined in relation to the collateral's appraised value. For loans

that are not deemed to be collateral-dependent, the amount of charge-offs may differ from the collateral's appraised value because there is additional support for the loan, such as cash flow from other sources.

The reserve for unfunded credit commitments includes loss exposure from Sterling's mortgage banking operations. 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 have borrower misrepresentations.

Table of Contents

While management uses available information to provide for loan losses, the ultimate collectability of a substantial portion of the loan portfolio and the need for future additions to the allowance will be influenced by changes in economic conditions and other relevant factors. There can be no assurance that the allowance for credit losses will be adequate to cover all losses, but management believes the allowance for credit losses was appropriate at September 30, 2012.

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

A deferred tax asset valuation allowance was established during 2009 due to the three year cumulative loss and uncertainty at that time regarding Sterling's ability to generate future taxable income. Reversal of the deferred tax asset valuation allowance occurred during the quarter ended June 30, 2012, which marked the sixth consecutive quarter of profitability for Sterling. Prior to reversing the allowance, management analyzed both positive and negative evidence that could affect the realization of the deferred tax asset. Based on the earnings performance trend and projections of income through 2013, improvement in asset quality, higher net interest margin and improvements in other key financial ratios, expectations of continued profitability, the length of the carry-forward period for its net operating losses and tax credits, an analysis of the reversal of existing temporary differences, and an evaluation of its loss carry-back ability and tax planning strategies, Sterling determined that it was more likely than not that the net deferred tax asset would be realized. This assessment was updated as of September 30, 2012, resulting in the same conclusion.

Regulation and Compliance

Sterling, as a bank holding company, is subject to ongoing comprehensive examination and regulation by the Federal Reserve Bank of San Francisco (the "Reserve Bank"), and Sterling Bank, as a Washington state-chartered bank, is subject to ongoing comprehensive regulation and examination by the Washington Department of Financial Institutions (the "WDFI") and the FDIC. Sterling Bank is further subject to standard Federal Reserve regulations related to deposit reserves and certain other matters.

During the first quarter of 2012, Sterling Bank's Memorandum of Understanding with the FDIC was terminated. This agreement had been in place since the fourth quarter of 2009, and its termination reduces certain regulatory constraints that were imposed upon Sterling Bank under the terms of the agreement. The agreement was terminated as a result of Sterling Bank's compliance with the terms of the agreement, including the return to a well-capitalized status.

Also during the first quarter of 2012, Sterling's written agreement with the Reserve Bank was terminated. As a result, Sterling is no longer required to obtain Reserve Bank approval before paying dividends, or accepting dividends from its subsidiary bank. However, Sterling Bank remains subject to various federal and state statutory provisions and regulations that limit the payment of dividends, and must obtain approval from the WDFI prior to paying a dividend to Sterling.

On June 7, 2012, the Federal Reserve issued proposed capital regulations consistent with Basel III, the global regulatory banking standard. The proposal includes a new capital standard consisting of common equity tier 1 capital, increases in the level of capital required to be held by financial institutions, and a requirement for a capital conservation buffer. Aspects of the proposal could introduce volatility to capital levels, such as the inclusion in tier 1 capital of unrealized gains and losses on available for sale securities. Revisions to risk weightings include application of a more risk-sensitive treatment to residential mortgage exposures and to past due or nonaccrual loans. Trust preferred junior subordinated debentures would be phased out as a component of tier 1 capital. As of the date of this filing, final regulations have not been issued.

Table of Contents

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 include, but are not limited to, statements about Sterling's plans, objectives, expectations, strategies and intentions and other statements contained in this report that are not historical facts and pertain to Sterling's future operating results and capital position, including Sterling's ability to reduce future loan losses, improve its deposit mix, execute its asset resolution initiatives, execute its lending initiatives, contain costs and potential liabilities, realize operating efficiencies, execute its business strategy, make dividend payments, compete in the marketplace, and provide increased customer support and service. When used in this report, the words “expects,” “anticipates,” “intends,” “plans,” “believes,” “seeks,” “estimates” and similar expressions are generally intended to identify forward-looking statements.

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:

- the possibility of continued adverse economic developments that may, among other things, increase default and delinquency risks in Sterling's loan portfolios;
- shifts in market interest rates that may result in lower interest rate margins;
- shifts in the demand for loans and other products;
- changes in the monetary and fiscal policies of the federal government;
- changes in laws, regulations and the competitive environment;
- lower-than-expected revenue or cost savings or other issues in connection with mergers and acquisitions;
- exposure to material litigation; and
- changes in accounting rules.

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 “Risk Factors” in Sterling's Annual Report on Form 10-K for the fiscal year ended December 31, 2011.

Item 3 Quantitative and Qualitative Disclosures About Market Risk

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

Item 4 Controls and Procedures

Disclosure Controls and Procedures

Sterling's management, with the participation of Sterling's principal executive officer and principal financial officer, has evaluated the effectiveness of Sterling's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities and Exchange Act of 1934 (the “Exchange Act”) as of the end of the period covered by this report. Based on such evaluation, Sterling's principal executive officer and principal financial officer have concluded that, as of the end of such period, Sterling's disclosure controls and procedures are effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by Sterling in the reports that it files or submits under the Exchange Act.

Changes in Internal Control Over Financial Reporting

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

Table of Contents

PART II – Other Information

Item 1 Legal Proceedings

On March 22, 2012, Sterling and its subsidiary Sterling Savings Bank were named as defendants in a purported class action lawsuit filed by a Washington customer of Sterling Savings Bank in King County, Washington, Superior Court, and on May 25, 2012, Sterling Savings Bank was named a defendant in a similar purported class action lawsuit filed on behalf of a customer in the U.S. District Court of Oregon. These suits challenged the manner in which overdraft fees were charged and the disclosures related to posting order of debit card and ATM transactions, and alleged claims for breach of contract, breach of the covenant of good faith and fair dealing, unconscionability, conversion, unjust enrichment, and a violation of state consumer protection laws. The two suits encompassed claims on behalf of Sterling Savings Bank customers from the five states in which Sterling Savings Bank presently conducts business. On October 17, 2012, Sterling announced the dismissal of the plaintiffs' claims.

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 9, 2010. On June 18, 2010, the lead plaintiff filed a consolidated complaint (the "Complaint"). The Complaint purports to be brought on behalf of a class of persons who purchased or otherwise acquired Sterling's stock during the period from July 23, 2008 to October 15, 2009. The Complaint alleges that defendants violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 by failing to disclose the extent of Sterling's delinquent commercial real estate, construction and land development loans, properly record losses for impaired loans, and properly reserve for loan losses, thereby causing Sterling's stock price to be artificially inflated during the purported class period. Plaintiffs seek unspecified damages and attorneys' fees and costs. Sterling believes the lawsuit is without merit and intends to defend against it vigorously. On August 30, 2010, Sterling moved to dismiss the Complaint. On March 2, 2011, after complete briefing, the court held a hearing on the motion to dismiss. The court has not yet issued an order on the motion, but recently indicated that it intends to do so in the near future. 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 reasonably 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 the 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 the Employee Retirement Income Security Act of 1974, as amended ("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. On September 26, 2012, Sterling received a letter from the U.S. Department of Labor (the "Department of Labor") containing similar allegations as those set forth in the Complaint, demanding that the violations alleged in the

Department of Labor's letter be corrected and notifying Sterling that the Department of Labor may take legal action in connection with such allegations, including assessing a civil money penalty. Sterling believes the Complaint, and Department of Labor allegations, are without merit and intends to defend against them vigorously. A hearing on the motion to dismiss the Complaint occurred on March 22, 2011, with the court indicating that it would take the motion under submission. The court has not yet issued an order on the motion, but recently indicated that it intends to do so in the near future. Failure by Sterling to obtain a favorable resolution of the claims set forth in the Complaint or in the letter from the Department of Labor 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 reasonably estimable in amount.

Table of Contents

Item 1A Risk Factors

You should carefully consider the risks and uncertainties we describe in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011 before deciding to invest in, or retain, shares of our common stock. These are not the only risks and uncertainties that we face. Additional risks and uncertainties that we do not currently know about or that we currently believe are immaterial, or that we have not predicted, may also harm our business operations or adversely affect us. If any of these risks or uncertainties actually occurs, our business, financial condition, operating results or liquidity could be materially harmed.

Item 2 Unregistered Sales of Equity Securities and Use of Proceeds

The following table presents Sterling's repurchase during the quarter ended September 30, 2012 of a warrant held by the U.S. Treasury. Upon repurchase, the warrant was cancelled.

| 2012 | Number of shares issuable under the warrant purchased | Average price paid per share |
|-----------|---|------------------------------|
| July | 0 | \$0.00 |
| August | 0 | 0.00 |
| September | 97,541 | 8.46 |
| Total | 97,541 | \$8.46 |

Item 3 Defaults Upon Senior Securities

Not applicable.

Item 4 Mine Safety Disclosures

Not applicable.

Item 5 Other Information

Not applicable.

Item 6 Exhibits

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

Table of Contents

STERLING FINANCIAL CORPORATION

Signatures

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

November 6, 2012

Date

STERLING FINANCIAL CORPORATION
(Registrant)

By: /s/ Robert G. Butterfield
Robert G. Butterfield
Senior Vice President, Controller, and
Principal Accounting Officer

55

Table of Contents

Exhibit No. Exhibit Index

- 3.1 Restated Articles of Incorporation of Sterling. Filed as Exhibit 4.1 to Sterling's Amendment No. 1 to the Registration Statement on Form S-3 dated May 8, 2009 and incorporated by reference herein.
- 3.2 Articles of Amendment of Restated Articles of Incorporation of Sterling increasing the authorized shares of common stock. Filed as Exhibit 4.2 to Sterling's Amendment No. 1 to the Registration Statement on Form S-3 dated September 21, 2009 and incorporated by reference herein.
- 3.3 Articles of Amendment to Sterling's Restated Articles of Incorporation designating Fixed Rate Cumulative Mandatorily Convertible Preferred Stock, Series C. Filed as Exhibit 3.1 to Sterling's Current Report on Form 8-K dated August 30, 2010 and incorporated by reference herein.
- 3.4 Articles of Amendment to Sterling's Restated Articles of Incorporation eliminating par value of Sterling Common Stock. Filed as Exhibit 3.2 to Sterling's Current Report on Form 8-K dated August 30, 2010 and incorporated by reference herein.
- 3.5 Articles of Amendment to Sterling's Restated Articles of Incorporation designating Fixed Rate Cumulative Mandatorily Convertible Preferred Stock, Series B. Filed as Exhibit 3.3 to Sterling's Current Report on Form 8-K dated August 30, 2010 and incorporated by reference herein.
- 3.6 Articles of Amendment to Sterling's Restated Articles of Incorporation designating Fixed Rate Cumulative Mandatorily Convertible Preferred Stock, Series D. Filed as Exhibit 3.4 to Sterling's Current Report on Form 8-K dated August 30, 2010 and incorporated by reference herein.
- 3.7 Articles of Amendment to Sterling's Restated Articles of Incorporation increasing the authorized shares of common stock. Filed as exhibit 3.7 to Sterling's Amendment No. 1 to the Registration Statement on Form S-1 dated November 3, 2010 and incorporated by reference herein.
- 3.8 Articles of Amendment to Sterling's Restated Articles of Incorporation reducing the authorized shares of common stock. Filed as Exhibit 3.1 to Sterling's Current Report on Form 8-K dated November 18, 2010 and incorporated by reference herein.
- 3.9 Articles of Amendment to Sterling's Restated Articles of Incorporation regarding certain transfer restrictions. Filed as Exhibit 3.9 to Sterling's Annual Report on Form 10-K for the year ended December 31, 2010 dated March 8, 2011 and incorporated by reference herein.
- 3.10 Amended and Restated Bylaws of Sterling. Filed as Exhibit 3.1 to Sterling's Current Report on Form 8-K dated April 25, 2011, and incorporated by referenced herein.
- 4.1 Reference is made to Exhibits 3.1 through 3.10.
- 4.2 Form of Common Stock Certificate. Filed as Exhibit 4.3 to Sterling's Registration Statement on Form S-3 dated July 20, 2009 and incorporated by reference herein.
- 4.3 Shareholder Rights Plan, dated as of April 14, 2010, between Sterling Financial Corporation and American Stock Transfer & Trust Company, LLC, as Rights Agent, which includes the Form of Articles of Amendment to the Restated Articles of Incorporation of Sterling Financial Corporation (Series E Participating Cumulative Preferred Stock) as Exhibit A, the Summary of Terms of the Rights Agreement

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as Exhibit B and the Form of Right Certificate as Exhibit C. Filed as Exhibit 4.1 to Sterling's Current Report on Form 8-K filed on April 15, 2010 and incorporated by reference herein.

4.4 First Amendment to Shareholder Rights Plan, dated as of December 8, 2010, between Sterling Financial Corporation and American Stock Transfer & Trust Company, LLC, as Rights Agent. Filed as Exhibit 4.1 to Sterling's Current Report on Form 8-K filed on December 10, 2010 and incorporated by reference herein.

4.5 Form of Warrant to Purchase Shares of Sterling Common Stock, dated August 26, 2010 and issued to 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. Filed as Exhibit 4.7 to Sterling's Registration Statement on Form S-1 dated September 24, 2010 and incorporated by reference herein.

4.6 Form of Warrant to Purchase Shares of Sterling Common Stock, dated August 26, 2010 and issued to Warburg Pincus Private Equity X, L.P. Filed as Exhibit 4.8 to Sterling's Registration Statement on Form S-1 dated September 24, 2010 and incorporated by reference herein.

4.7 Sterling has outstanding certain long-term debt. None of such debt exceeds ten percent of Sterling's total assets; therefore, copies of the constituent instruments defining the rights of the holders of such debt are not included as exhibits. Copies of instruments with respect to such long-term debt will be furnished to the Securities and Exchange Commission upon request.

E-1

Table of Contents

- 31.1 Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. Filed herewith.
- 31.2 Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. Filed herewith.
- 32.1 Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. Furnished herewith.
- 32.2 Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. Furnished herewith.
- 101.INS* XBRL Instance Document. Furnished herewith.
- 101.SCH* XBRL Taxonomy Extension Schema. Furnished herewith.
- 101.CAL* XBRL Taxonomy Extension Calculation Linkbase. Furnished herewith.
- 101.LAB* XBRL Taxonomy Extension Label Linkbase. Furnished herewith.
- 101.PRE* XBRL Taxonomy Extension Presentation Linkbase. Furnished herewith.

* Pursuant to Rule 406T of Regulation S-T, these interactive data files are furnished and not deemed filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, or Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under these sections.