

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
<b>ASSETS:</b>		
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
<b>LIABILITIES:</b>		
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
<b>SHAREHOLDERS' EQUITY:</b>		
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,	2011
	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	Pre-Modification Recorded Investment