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

Registration Statement No. 333-169579

PROSPECTUS SUPPLEMENT

(To Prospectus dated November 16, 2010)

STERLING FINANCIAL CORPORATION

63,764,208 Shares of Common Stock

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

RECENT DEVELOPMENTS

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

March 9, 2011

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the year ended DECEMBER 31, 2010

OR

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

For the transition period from to

COMMISSION FILE NUMBER 001-34696

STERLING FINANCIAL CORPORATION

(Exact name of registrant as specified in its charter)

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

111 North Wall Street, Spokane, Washington 99201

(Address of principal executive offices) (Zip code)

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

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

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

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

(Title of class) Common Stock

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

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

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

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

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

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

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

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

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

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

DOCUMENTS INCORPORATED BY REFERENCE

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

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STERLING FINANCIAL CORPORATION

DECEMBER 31, 2010 ANNUAL REPORT ON FORM 10-K

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PART I

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

Item 1. Business

General

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

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

Recent Developments

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

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

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

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

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

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

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

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

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

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

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

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

Business Strategy

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Profitability Drivers

Achieving profitability depends upon executing the following strategies:

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

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

Segments

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

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

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

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

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

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

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

Lending Activities

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

From time to time, Sterling may enter into interest rate swap transactions with loan customers. The interest rate risk on these swap transactions is managed by entering into offsetting interest rate swap agreements with various counterparties (broker-dealers or dealers). The counterparty swap agreements include certain representations, warranties and covenants, which include terms that allow for an early termination in the event of default. Failure to maintain a well-capitalized position is one event that may be considered a default, and counterparties to the swap agreements could require an early termination settlement or an increase in the collateral to secure derivative instruments that are in net liability positions to Sterling. During 2010, no counterparties declared an early termination event. As a result of the Recapitalization Transactions, management believes that Sterling is not likely to experience an early termination event in connection with its capital levels. Both customer and dealer related interest rate derivatives are carried at fair value by Sterling.

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

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

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

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

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

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

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

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

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

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

Investments and Mortgage-Backed Securities

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

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

Sources of Funds

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

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