

STERLING FINANCIAL CORP /WA/  
Form 10-Q  
November 07, 2013  
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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

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FORM 10-Q

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(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, 2013

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

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STERLING FINANCIAL CORPORATION  
(Exact name of registrant as specified in its charter)

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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)

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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, 2013 |
| Common Stock | 62,310,878                         |



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

|                                                                                                         | September 30,<br>2013 | December 31,<br>2012 |
|---------------------------------------------------------------------------------------------------------|-----------------------|----------------------|
| <b>ASSETS:</b>                                                                                          |                       |                      |
| Cash and cash equivalents:                                                                              |                       |                      |
| Interest bearing                                                                                        | \$223,338             | \$173,962            |
| Noninterest bearing                                                                                     | 119,690               | 125,916              |
| Total cash and cash equivalents                                                                         | 343,028               | 299,878              |
| Restricted cash                                                                                         | 6,651                 | 31,672               |
| Investments and mortgage-backed securities ("MBS"):                                                     |                       |                      |
| Available for sale                                                                                      | 1,498,377             | 1,513,157            |
| Held to maturity                                                                                        | 175                   | 206                  |
| Loans held for sale (\$190,635 and \$465,983 at fair value)                                             | 245,783               | 465,983              |
| Loans receivable, net (\$26,931 and \$23,177 at fair value)                                             | 7,024,326             | 6,101,749            |
| Accrued interest receivable                                                                             | 29,614                | 28,019               |
| Other real estate owned, net ("OREO")                                                                   | 17,464                | 25,042               |
| Properties and equipment, net                                                                           | 100,370               | 93,850               |
| Bank-owned life insurance ("BOLI")                                                                      | 189,906               | 179,828              |
| Goodwill                                                                                                | 36,633                | 22,577               |
| Other intangible assets, net                                                                            | 16,154                | 19,072               |
| Mortgage servicing rights, net                                                                          | 57,030                | 32,420               |
| Deferred tax asset, net                                                                                 | 282,561               | 292,082              |
| Other assets, net                                                                                       | 136,264               | 131,375              |
| Total assets                                                                                            | \$9,984,336           | \$9,236,910          |
| <b>LIABILITIES:</b>                                                                                     |                       |                      |
| Deposits:                                                                                               |                       |                      |
| Noninterest bearing                                                                                     | \$1,818,194           | \$1,702,740          |
| Interest bearing                                                                                        | 5,036,248             | 4,733,377            |
| Total deposits                                                                                          | 6,854,442             | 6,436,117            |
| Advances from Federal Home Loan Bank ("FHLB")                                                           | 1,027,807             | 605,330              |
| Securities sold under repurchase agreements                                                             | 534,669               | 586,867              |
| Junior subordinated debentures                                                                          | 245,298               | 245,294              |
| Accrued interest payable                                                                                | 4,202                 | 4,229                |
| Accrued expenses and other liabilities                                                                  | 102,037               | 141,150              |
| Total liabilities                                                                                       | 8,768,455             | 8,018,987            |
| <b>SHAREHOLDERS' EQUITY:</b>                                                                            |                       |                      |
| Preferred stock, 10,000,000 shares authorized; no shares outstanding                                    | 0                     | 0                    |
| Common stock, 151,515,151 shares authorized; 62,314,862 and 62,207,529 shares outstanding, respectively | 1,972,021             | 1,968,025            |
| Accumulated other comprehensive income                                                                  | 29,919                | 60,712               |
| Accumulated deficit                                                                                     | (786,059)             | (810,814)            |
| Total shareholders' equity                                                                              | 1,215,881             | 1,217,923            |
| Total liabilities and shareholders' equity                                                              | \$9,984,336           | \$9,236,910          |

See notes to consolidated financial statements.



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

|                                                                 | Three Months Ended<br>September 30, |            | Nine Months Ended<br>September 30, |            |
|-----------------------------------------------------------------|-------------------------------------|------------|------------------------------------|------------|
|                                                                 | 2013                                | 2012       | 2013                               | 2012       |
| Interest income:                                                |                                     |            |                                    |            |
| Loans                                                           | \$86,099                            | \$83,110   | \$251,722                          | \$248,488  |
| MBS                                                             | 8,079                               | 10,361     | 22,709                             | 38,632     |
| Investments and cash equivalents                                | 2,266                               | 2,520      | 6,787                              | 7,826      |
| Total interest income                                           | 96,444                              | 95,991     | 281,218                            | 294,946    |
| Interest expense:                                               |                                     |            |                                    |            |
| Deposits                                                        | 6,041                               | 8,981      | 18,386                             | 30,004     |
| Short-term borrowings                                           | 303                                 | 2,346      | 1,037                              | 6,377      |
| Long-term borrowings                                            | 7,552                               | 9,356      | 21,939                             | 29,994     |
| Total interest expense                                          | 13,896                              | 20,683     | 41,362                             | 66,375     |
| Net interest income                                             | 82,548                              | 75,308     | 239,856                            | 228,571    |
| Provision for credit losses                                     | 0                                   | 2,000      | 0                                  | 10,000     |
| Net interest income after provision for credit losses           | 82,548                              | 73,308     | 239,856                            | 218,571    |
| Noninterest income:                                             |                                     |            |                                    |            |
| Fees and service charges                                        | 15,380                              | 14,675     | 45,128                             | 41,546     |
| Mortgage banking operations                                     | 13,494                              | 26,410     | 50,468                             | 69,135     |
| BOLI                                                            | 1,640                               | 1,660      | 4,621                              | 7,175      |
| Gains on sales of securities                                    | 0                                   | 3,129      | 0                                  | 12,592     |
| Other-than-temporary impairment credit losses on securities (1) | 0                                   | 0          | 0                                  | (6,819)    |
| Charge on prepayment of debt                                    | 0                                   | 0          | 0                                  | (2,664)    |
| Gains on other loan sales                                       | 1,135                               | 476        | 2,354                              | 3,887      |
| Other                                                           | 241                                 | 348        | 8,888                              | (1,826)    |
| Total noninterest income                                        | 31,890                              | 46,698     | 111,459                            | 123,026    |
| Noninterest expense                                             | 85,334                              | 89,408     | 248,941                            | 265,664    |
| Income before income taxes                                      | 29,104                              | 30,598     | 102,374                            | 75,933     |
| Income tax (provision) benefit                                  | (8,056)                             | ) 0        | (30,887)                           | ) 288,842  |
| Net income                                                      | \$21,048                            | \$30,598   | \$71,487                           | \$364,775  |
| Earnings per share - basic                                      | \$0.34                              | \$0.49     | \$1.15                             | \$5.87     |
| Earnings per share - diluted                                    | \$0.33                              | \$0.49     | \$1.13                             | \$5.81     |
| Dividends declared per share                                    | \$0.20                              | \$0.15     | \$0.75                             | \$0.15     |
| Weighted average shares outstanding - basic                     | 62,309,270                          | 62,139,833 | 62,280,542                         | 62,110,498 |
| Weighted average shares outstanding - diluted                   | 63,461,018                          | 62,845,864 | 63,271,060                         | 62,745,177 |

(1) The other-than-temporary impairment (1) 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.

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

|                                                                      | Three Months Ended<br>September 30, |           |
|----------------------------------------------------------------------|-------------------------------------|-----------|
|                                                                      | 2013                                | 2012      |
| Net income                                                           | \$21,048                            | \$30,598  |
| Beginning balance, accumulated other comprehensive income            | \$30,751                            | \$67,102  |
| Other comprehensive (loss) income:                                   |                                     |           |
| Change in unrealized gains on investments and MBS available for sale | (1,321 )                            | 16,235    |
| Realized net gains reclassified from other comprehensive income      | 0                                   | (3,129 )  |
| Less deferred income tax benefit (provision)                         | 489                                 | (4,945 )  |
| Net other comprehensive (loss) income                                | (832 )                              | 8,161     |
| Ending balance, accumulated other comprehensive income               | \$29,919                            | \$75,263  |
| Comprehensive income                                                 | \$20,216                            | \$38,759  |
|                                                                      | Nine Months Ended<br>September 30,  |           |
|                                                                      | 2013                                | 2012      |
| Net income                                                           | \$71,487                            | \$364,775 |
| Beginning balance, accumulated other comprehensive income            | \$60,712                            | \$61,115  |
| Other comprehensive (loss) income:                                   |                                     |           |
| Change in unrealized gains on investments and MBS available for sale | (48,878 )                           | 28,547    |
| Realized net gains reclassified from other comprehensive income      | 0                                   | (5,773 )  |
| Less deferred income tax benefit (provision)                         | 18,085                              | (8,626 )  |
| Net other comprehensive (loss) income                                | (30,793 )                           | 14,148    |
| Ending balance, accumulated other comprehensive income               | \$29,919                            | \$75,263  |
| Comprehensive income                                                 | \$40,694                            | \$378,923 |

For the periods presented, accumulated other comprehensive income was comprised solely of unrealized market value adjustments on available for sale securities. The realized portion reclassified out of other comprehensive income is reflected on the income statement in gains on sales of securities and other-than-temporary impairment.

See notes to consolidated financial statements.

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

|                                                                                   | Nine Months Ended September |                |
|-----------------------------------------------------------------------------------|-----------------------------|----------------|
|                                                                                   | 30,                         |                |
|                                                                                   | 2013                        | 2012           |
| Cash flows from operating activities:                                             |                             |                |
| Net income                                                                        | \$71,487                    | \$364,775      |
| Adjustments to reconcile net income to net cash provided by operating activities: |                             |                |
| Provision for credit losses                                                       | 0                           | 10,000         |
| Net gain on sales of loans                                                        | (42,719                     | ) (71,482 )    |
| Net gain on sales of investments and MBS                                          | 0                           | (12,592 )      |
| Net (gain) loss on mortgage servicing rights                                      | (6,105                      | ) 984          |
| Other-than-temporary impairment credit losses on securities                       | 0                           | 6,819          |
| Stock based compensation                                                          | 3,128                       | 2,756          |
| Loss on OREO                                                                      | 1,141                       | 32             |
| Release of DTA valuation allowance                                                | 0                           | (288,842 )     |
| Increase in cash surrender value of BOLI                                          | (4,419                      | ) (6,924 )     |
| Depreciation and amortization                                                     | 32,452                      | 33,871         |
| Bargain purchase gain                                                             | (7,544                      | ) 0            |
| Change in:                                                                        |                             |                |
| Accrued interest receivable                                                       | (785                        | ) 4,325        |
| Prepaid expenses and other assets                                                 | 12,503                      | (23,295 )      |
| Accrued interest payable                                                          | (67                         | ) (16,116 )    |
| Accrued expenses and other liabilities                                            | (46,044                     | ) 19,606       |
| Proceeds from sales of loans originated for sale                                  | 2,278,291                   | 1,937,131      |
| Loans originated for sale                                                         | (1,964,100                  | ) (2,010,310 ) |
| Net cash provided by (used in) operating activities                               | 327,219                     | (49,262 )      |
| Cash flows from investing activities:                                             |                             |                |
| Change in restricted cash                                                         | 25,021                      | (11,042 )      |
| Net change in loans                                                               | (661,835                    | ) (317,773 )   |
| Proceeds from sales of loans                                                      | 41,272                      | 75,689         |
| Purchase of investment securities                                                 | 0                           | (3,734 )       |
| Proceeds from maturities of investment securities                                 | 2,778                       | 18,939         |
| Proceeds from sale of investment securities                                       | 0                           | 179,235        |
| Purchase of MBS                                                                   | (322,965                    | ) (287,849 )   |
| Principal payments received on MBS                                                | 278,527                     | 467,792        |
| Proceeds from sales of MBS                                                        | 0                           | 326,915        |
| Proceeds from BOLI death benefits                                                 | 0                           | 3,714          |
| Office properties and equipment, net                                              | (14,568                     | ) (14,144 )    |
| Improvements and other changes to OREO                                            | (321                        | ) (1,214 )     |
| Proceeds from sales of OREO                                                       | 28,462                      | 67,200         |
| Net change in cash and cash equivalents from acquisitions                         | (115,768                    | ) 121,098      |
| Net cash (used in) provided by investing activities                               | \$(739,397                  | ) \$624,826    |

See notes to consolidated financial statements.



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

|                                                        | Nine Months Ended September<br>30, |              |
|--------------------------------------------------------|------------------------------------|--------------|
|                                                        | 2013                               | 2012         |
| Cash flows from financing activities:                  |                                    |              |
| Net change in deposits                                 | \$131,857                          | \$(441,827 ) |
| Advances from FHLB                                     | 1,385,000                          | 50,000       |
| Repayment of advances from FHLB                        | (963,472 )                         | (300,157 )   |
| Net change in short term repurchase agreements         | (2,198 )                           | (13,216 )    |
| Payments under structured repurchase agreements        | (50,000 )                          | (100,000 )   |
| Proceeds from stock issuance, net                      | 868                                | 572          |
| Cash dividends paid                                    | (46,727 )                          | (9,322 )     |
| Net cash provided by (used in) financing activities    | 455,328                            | (813,950 )   |
| Net change in cash and cash equivalents                | 43,150                             | (238,386 )   |
| Cash and cash equivalents, beginning of period         | 299,878                            | 470,599      |
| Cash and cash equivalents, end of period               | \$343,028                          | \$232,213    |
| Supplemental disclosures:                              |                                    |              |
| Cash paid during the period for:                       |                                    |              |
| Interest                                               | \$41,389                           | \$82,358     |
| Income taxes, net                                      | 634                                | 81           |
| Noncash financing and investing activities:            |                                    |              |
| Foreclosed real estate acquired in settlement of loans | 17,329                             | 30,683       |

See notes to consolidated financial statements.

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STERLING FINANCIAL CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
SEPTEMBER 30, 2013

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, 2012. 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 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.

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

In February 2013, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2013-04, "Obligations Resulting from Joint and Several Liability Arrangements for Which the Total Amount of the Obligation Is Fixed at the Reporting Date." ASU 2013-04 provides guidance for the recognition, measurement, and disclosure of such obligations. ASU 2013-04 is effective for fiscal years beginning after December 15, 2013, and is not expected to have a material impact on Sterling's consolidated financial statements.

In July 2013, the FASB issued ASU 2013-11, "Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists." ASU 2013-11 provides guidance on the presentation of unrecognized tax benefits related to any disallowed portion of net operating loss carryforwards, similar tax losses, or tax credit carryforwards, if they exist. ASU 2013-11 is effective for fiscal years beginning after December 15, 2013, and is not expected to have a material impact on Sterling's consolidated financial statements.

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## 2. Business Combinations:

Boston Private Bank and Trust Company. On May 10, 2013, Sterling paid \$123.0 million in cash to acquire the Puget Sound operations of Boston Private Bank & Trust Company ("Boston Private"), a wholly owned subsidiary of Boston Private Financial Holdings, Inc. The Boston Private Puget Sound offices were located in Seattle, Bellevue and Redmond, Washington. Upon acquisition, the Boston Private Seattle branch was consolidated into one of Sterling's existing Seattle branches. The following table summarizes the amounts recorded at closing:

|                           | May 10, 2013<br>(in thousands) |
|---------------------------|--------------------------------|
| Cash and cash equivalents | \$340                          |
| Loans receivable, net     | 273,353                        |
| Goodwill                  | 14,056                         |
| Core deposit intangible   | 1,674                          |
| Other assets              | 2,721                          |
| Total assets acquired     | \$292,144                      |
| Deposits                  | \$168,246                      |
| Other liabilities         | 913                            |
| Total liabilities assumed | 169,159                        |
| Net assets acquired       | \$122,985                      |

The recorded goodwill represents the inherent value of the Boston Private transaction, which expands Sterling's presence in the Puget Sound market through the addition of two branch offices and the associated customer relationships. The additional branches are along the I-5 corridor, which Sterling identified as its primary focus for growth. The amount of goodwill deductible for income tax purposes is approximately equivalent to the recorded book value. The core deposit intangible will be amortized on an accelerated basis over approximately ten years.

As of May 10, 2013, the unpaid principal balance and contractual interest ("contractual cash flows") on purchased loans was \$280.7 million. Sterling estimated that \$3.5 million of these cash flows would be uncollectable, resulting in a combined credit and interest rate discount of \$5.1 million being recorded on these loans. As of the acquisition date, none of the loans purchased from Boston Private exhibited evidence of credit deterioration.

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American Heritage Holdings. On February 28, 2013, Sterling paid \$6.5 million in cash and paid off an existing note payable of \$2.2 million for a total of \$8.7 million in consideration to acquire American Heritage Holdings, the holding company for Borrego Springs Bank, N.A. ("Borrego"). Immediately following the acquisition, Borrego was merged with and into Sterling Bank. As a result of this transaction, Sterling has expanded its SBA lending platform and added depository branches in Southern California. The following table summarizes the amounts recorded at closing:

|                           | February 28, 2013<br>(in thousands) |
|---------------------------|-------------------------------------|
| Cash and cash equivalents | 15,626                              |
| Investments and MBS       | 1,030                               |
| Loans receivable, net     | 97,262                              |
| Core deposit intangible   | 453                                 |
| Other assets              | 27,197                              |
| Total assets acquired     | \$ 141,568                          |
| Deposits                  | \$ 118,221                          |
| Other liabilities         | 7,054                               |
| Total liabilities assumed | 125,275                             |
| Net assets acquired       | 16,293                              |
| Consideration paid        | 8,749                               |
| Bargain purchase gain     | \$ 7,544                            |

Sterling recognized a bargain purchase gain of \$7.5 million in the transaction for the net assets acquired in excess of the purchase price, primarily due to a limited market for Borrego's assets, as well as Borrego's regulatory and capital constraints. The bargain purchase gain is included in other noninterest income on the income statement for the nine months ended September 30, 2013. The core deposit intangible will be amortized for 11 years on an accelerated basis. On the acquisition date of February 28, 2013, the contractual cash flows of purchased impaired loans, which are described in Note 4, from Borrego were \$16.1 million, cash flows expected to be collected \$13.6 million, and the fair value of the loans \$11.9 million, with \$9.8 million of these loans being guaranteed by government agencies.

As of February 28, 2013, the contractual cash flows on purchased loans that had not exhibited evidence of credit deterioration was \$83.3 million. Sterling estimated that \$3.9 million of these cash flows would be uncollectable, resulting in a combined credit and interest rate discount of \$4.5 million being recorded on these loans.

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First Independent Bank. On February 29, 2012, Sterling Bank completed its acquisition of the operations of First Independent Bank ("First Independent") of Vancouver, Washington, 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, 2013, the contingent consideration was paid in full. See Note 13. The following table summarizes the amounts recorded at closing:

|                           | February 29, 2012<br>(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 First Independent transaction expanded Sterling's presence in the Vancouver and Portland markets. 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. On the acquisition date of February 29, 2012, the contractual cash flows of purchased impaired loans from First Independent were \$24.4 million, cash flows expected to be collected \$17.2 million, and the fair value of the loans \$15.3 million.

As of February 29, 2012, the 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 certain First Independent stand alone amounts and pro forma Sterling and First Independent combined amounts as if the transaction had occurred on January 1, 2012. 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.

|                              | First Independent (stand alone)                             |                      | Pro Forma Combined    |                      |
|------------------------------|-------------------------------------------------------------|----------------------|-----------------------|----------------------|
|                              | Three Months<br>Ended                                       | Nine Months<br>Ended | Three Months<br>Ended | Nine Months<br>Ended |
|                              | September 30, 2012<br>(in thousands, except per share data) |                      |                       |                      |
| Net interest income          | \$5,104                                                     | \$16,204             | \$75,308              | \$235,052            |
| Noninterest income           | 1,247                                                       | 3,428                | 46,698                | 124,031              |
| Net income                   | 2,630                                                       | 8,638                | 30,598                | 368,989              |
| Earnings per share - basic   | 0.04                                                        | 0.14                 | 0.49                  | 5.94                 |
| Earnings per share - diluted | \$0.04                                                      | \$0.14               | \$0.49                | \$5.89               |



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## 3. Investments and MBS:

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

|                    | Amortized<br>Cost<br><br>(in thousands) | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair Value     |
|--------------------|-----------------------------------------|------------------------------|-------------------------------|----------------|
| September 30, 2013 |                                         |                              |                               |                |
| Available for sale |                                         |                              |                               |                |
| MBS                | \$ 1,300,288                            | \$ 20,362                    | \$(15,194)                    | ) \$ 1,305,456 |
| Municipal bonds    | 185,907                                 | 7,767                        | (925)                         | ) 192,749      |
| Other              | 162                                     | 10                           | 0                             | 172            |
| Total              | \$ 1,486,357                            | \$ 28,139                    | \$(16,119)                    | ) \$ 1,498,377 |
| Held to maturity   |                                         |                              |                               |                |
| Tax credits        | \$ 175                                  | \$ 0                         | \$ 0                          | \$ 175         |
| Total              | \$ 175                                  | \$ 0                         | \$ 0                          | \$ 175         |
| December 31, 2012  |                                         |                              |                               |                |
| Available for sale |                                         |                              |                               |                |
| MBS                | \$ 1,263,786                            | \$ 45,052                    | \$ 0                          | \$ 1,308,838   |
| Municipal bonds    | 188,467                                 | 16,452                       | (613)                         | ) 204,306      |
| Other              | 5                                       | 8                            | 0                             | 13             |
| Total              | \$ 1,452,258                            | \$ 61,512                    | \$(613)                       | ) \$ 1,513,157 |
| Held to maturity   |                                         |                              |                               |                |
| Tax credits        | \$ 206                                  | \$ 0                         | \$ 0                          | \$ 206         |
| Total              | \$ 206                                  | \$ 0                         | \$ 0                          | \$ 206         |

Sterling's MBS portfolio is comprised primarily of residential agency securities. Total sales of Sterling's securities during the periods ended September 30, 2013 and 2012 are summarized as follows:

|                    | Proceeds from<br>Sales<br><br>(in thousands) | Gross Realized<br>Gains | Gross Realized<br>Losses |
|--------------------|----------------------------------------------|-------------------------|--------------------------|
| Nine Months Ended: |                                              |                         |                          |
| September 30, 2013 | \$ 0                                         | \$ 0                    | \$ 0                     |
| September 30, 2012 | 506,150                                      | 12,666                  | (74)                     |

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The following table summarizes Sterling's investments and MBS that had a market value below their amortized cost as of September 30, 2013 and December 31, 2012, 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        |                   |
|--------------------|---------------------|-------------------|---------------------|-------------------|--------------|-------------------|
|                    | Market Value        | Unrealized Losses | Market Value        | Unrealized Losses | Market Value | Unrealized Losses |
| (in thousands)     |                     |                   |                     |                   |              |                   |
| September 30, 2013 |                     |                   |                     |                   |              |                   |
| MBS                | \$497,736           | \$(15,194 )       | \$0                 | \$0               | \$497,736    | \$(15,194 )       |
| Municipal bonds    | 4,763               | (157 )            | 12,551              | (768 )            | 17,314       | (925 )            |
| Other              | 0                   | 0                 | 0                   | 0                 | 0            | 0                 |
| Total              | \$502,499           | \$(15,351 )       | \$12,551            | \$(768 )          | \$515,050    | \$(16,119 )       |
| December 31, 2012  |                     |                   |                     |                   |              |                   |
| MBS                | \$0                 | \$0               | \$0                 | \$0               | \$0          | \$0               |
| Municipal bonds    | 0                   | 0                 | 12,921              | (613 )            | 12,921       | (613 )            |
| Other              | 0                   | 0                 | 0                   | 0                 | 0            | 0                 |
| Total              | \$0                 | \$0               | \$12,921            | \$(613 )          | \$12,921     | \$(613 )          |

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"). During the nine months ended September 30, 2013, no securities were determined to be other-than-temporarily impaired, while during the comparative 2012 period, \$6.8 million of OTTI was recognized on a single issuer trust preferred security. The security is no longer owned by Sterling.

The following table presents the amortized cost and fair value of available for sale and held to maturity securities as of September 30, 2013, 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   | Fair Value | Amortized Cost     | Fair Value  |
| (in thousands)                         |                  |            |                    |             |
| Due within one year                    | \$0              | \$0        | \$0                | \$0         |
| Due after one year through five years  | 0                | 0          | 9,404              | 9,954       |
| Due after five years through ten years | 0                | 0          | 90,788             | 90,357      |
| Due after ten years                    | 175              | 175        | 1,386,165          | 1,398,066   |
| Total                                  | \$175            | \$175      | \$1,486,357        | \$1,498,377 |



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## 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,<br>2013 | December 31,<br>2012 |
|---------------------------------|-----------------------|----------------------|
|                                 | (in thousands)        |                      |
| Residential real estate         | \$1,052,381           | \$806,722            |
| Commercial real estate ("CRE"): |                       |                      |
| Investor CRE                    | 1,125,477             | 1,219,847            |
| Multifamily                     | 2,029,820             | 1,580,289            |
| Construction                    | 52,929                | 74,665               |
| Total CRE                       | 3,208,226             | 2,874,801            |
| Commercial:                     |                       |                      |
| Owner occupied CRE              | 1,404,006             | 1,276,591            |
| Commercial & Industrial ("C&I") | 681,666               | 540,499              |
| Total commercial                | 2,085,672             | 1,817,090            |
| Consumer                        | 807,964               | 754,621              |
| Gross loans receivable          | 7,154,243             | 6,253,234            |
| Deferred loan costs (fees), net | 8,781                 | 2,860                |
| Allowance for loan losses       | (138,698              | ) (154,345           |
| Net loans receivable            | \$7,024,326           | \$6,101,749          |

As of September 30, 2013 and December 31, 2012, loans pledged as collateral for borrowings from the FHLB and the Federal Reserve were \$4.93 billion and \$4.15 billion, respectively.

Loans receivable include purchased impaired loans, which are loans acquired that are deemed to exhibit evidence of credit deterioration since origination and therefore, are classified as impaired. The accounting for purchased impaired loans is updated quarterly for changes in the loans' cash flow expectations, and reflected in interest income over the life of the loans as accretable yield. As of September 30, 2013, no allowance for credit losses was recorded in connection with purchased impaired loans, and the unpaid principal balance and carrying amount of these loans were \$30.5 million and \$18.2 million, respectively. The following table presents a roll-forward of accretable yield over the periods presented:

|                              | Three Months Ended September 30, |         | Nine Months Ended September 30, |         |
|------------------------------|----------------------------------|---------|---------------------------------|---------|
|                              | 2013                             | 2012    | 2013                            | 2012    |
|                              | (in thousands)                   |         |                                 |         |
| Beginning balance            | \$2,748                          | \$2,331 | \$1,332                         | \$0     |
| Additions                    | 0                                | 0       | 1,774                           | 1,923   |
| Accretion to interest income | (454                             | ) (223  | ) (1,156                        | ) (545  |
| Reclassifications            | 209                              | (678    | ) 553                           | 52      |
| Ending balance               | \$2,503                          | \$1,430 | \$2,503                         | \$1,430 |

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As of September 30, 2013 and December 31, 2012, net loans receivable included unamortized discounts on acquired loans of \$25.6 million and \$21.3 million, respectively. The following table presents, as of September 30, 2013, the five-year projected loan discount accretion to be recognized as interest income:

|                          | Amount<br>(in thousands) |
|--------------------------|--------------------------|
| Remainder of 2013        | \$1,620                  |
| Years ended December 31, |                          |
| 2014                     | 4,589                    |
| 2015                     | 2,982                    |
| 2016                     | 1,856                    |
| 2017                     | 1,284                    |
| 2018                     | 924                      |

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

|                                       | Residential<br>Real Estate<br>(in thousands) | Commercial<br>Real Estate | Commercial  | Consumer  | Unallocated | Total       |
|---------------------------------------|----------------------------------------------|---------------------------|-------------|-----------|-------------|-------------|
| September 30, 2013                    |                                              |                           |             |           |             |             |
| Loans receivable, gross:              |                                              |                           |             |           |             |             |
| Individually evaluated for impairment | \$0                                          | \$55,583                  | \$38,884    | \$0       | \$0         | \$94,467    |
| Collectively evaluated for impairment | 1,052,381                                    | 3,152,643                 | 2,046,788   | 807,964   | 0           | 7,059,776   |
| Total loans receivable, gross         | \$1,052,381                                  | \$3,208,226               | \$2,085,672 | \$807,964 | \$0         | \$7,154,243 |
| Allowance for loan losses:            |                                              |                           |             |           |             |             |
| Individually evaluated for impairment | \$0                                          | \$1,444                   | \$3,169     | \$0       | \$0         | \$4,613     |
| Collectively evaluated for impairment | 17,276                                       | 39,669                    | 39,442      | 25,220    | 12,478      | 134,085     |
| Total allowance for loan losses       | \$17,276                                     | \$41,113                  | \$42,611    | \$25,220  | \$12,478    | \$138,698   |
| December 31, 2012                     |                                              |                           |             |           |             |             |
| Loans receivable, gross:              |                                              |                           |             |           |             |             |
| Individually evaluated for impairment | \$9,134                                      | \$68,317                  | \$48,312    | \$494     | \$0         | \$126,257   |
| Collectively evaluated for impairment | 797,588                                      | 2,806,484                 | 1,768,778   | 754,127   | 0           | 6,126,977   |
| Total loans receivable, gross         | \$806,722                                    | \$2,874,801               | \$1,817,090 | \$754,621 | \$0         | \$6,253,234 |
| Allowance for loan losses:            |                                              |                           |             |           |             |             |
| Individually evaluated for impairment | \$365                                        | \$3,182                   | \$4,916     | \$0       | \$0         | \$8,463     |
| Collectively evaluated for impairment | 19,482                                       | 44,912                    | 36,958      | 25,602    | 18,928      | 145,882     |
| Total allowance for loan losses       | \$19,847                                     | \$48,094                  | \$41,874    | \$25,602  | \$18,928    | \$154,345   |

Loans collectively evaluated for impairment include purchased credit impaired loans, which were \$18.2 million as of September 30, 2013, and \$11.2 million as of December 31, 2012.

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

|                                          | Residential<br>Real Estate<br>(in thousands) | Commercial<br>Real Estate | Commercial | Consumer  | Unallocated | Total      |
|------------------------------------------|----------------------------------------------|---------------------------|------------|-----------|-------------|------------|
| 2013 third quarter activity              |                                              |                           |            |           |             |            |
| Allowance for loan losses:               |                                              |                           |            |           |             |            |
| Beginning balance, July 1                | \$18,989                                     | \$41,587                  | \$39,524   | \$27,744  | \$14,105    | \$141,949  |
| Provisions                               | (1,270)                                      | ) (659)                   | ) 2,820    | (1,364)   | ) (1,627)   | ) (2,100)  |
| Charge-offs                              | (752)                                        | ) (1,219)                 | ) (1,051)  | ) (1,466) | ) 0         | ) (4,488)  |
| Recoveries                               | 309                                          | 1,404                     | 1,318      | 306       | 0           | 3,337      |
| Ending balance, September 30             | 17,276                                       | 41,113                    | 42,611     | 25,220    | 12,478      | 138,698    |
| Reserve for unfunded credit commitments: |                                              |                           |            |           |             |            |
| Beginning balance, July 1                | 3,142                                        | 507                       | 2,552      | 3,247     | 57          | 9,505      |
| Provisions                               | 1,721                                        | 237                       | 342        | (206)     | ) 6         | 2,100      |
| Charge-offs                              | (1,064)                                      | ) 0                       | 0          | 0         | 0           | (1,064)    |
| Recoveries                               | 0                                            | 0                         | 0          | 0         | 0           | 0          |
| Ending balance, September 30             | 3,799                                        | 744                       | 2,894      | 3,041     | 63          | 10,541     |
| Total credit allowance                   | \$21,075                                     | \$41,857                  | \$45,505   | \$28,261  | \$12,541    | \$149,239  |
| 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  |

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|                                             | Residential<br>Real Estate<br>(in thousands) | Commercial<br>Real Estate | Commercial | Consumer | Unallocated | Total     |   |
|---------------------------------------------|----------------------------------------------|---------------------------|------------|----------|-------------|-----------|---|
| 2013 year to date                           |                                              |                           |            |          |             |           |   |
| Allowance for loan losses:                  |                                              |                           |            |          |             |           |   |
| Beginning balance,<br>January 1             | \$19,847                                     | \$48,094                  | \$41,874   | \$25,602 | \$18,928    | \$154,345 |   |
| Provisions                                  | (524                                         | ) (3,948                  | ) 3,029    | 3,193    | (6,450      | ) (4,700  | ) |
| Charge-offs                                 | (2,878                                       | ) (6,778                  | ) (5,151   | ) (4,613 | ) 0         | (19,420   | ) |
| Recoveries                                  | 831                                          | 3,745                     | 2,859      | 1,038    | 0           | 8,473     |   |
| Ending balance,<br>September 30             | 17,276                                       | 41,113                    | 42,611     | 25,220   | 12,478      | 138,698   |   |
| Reserve for unfunded<br>credit commitments: |                                              |                           |            |          |             |           |   |
| Beginning balance,<br>January 1             | 2,230                                        | 405                       | 2,806      | 2,118    | 443         | 8,002     |   |
| Provisions                                  | 3,730                                        | 339                       | 88         | 923      | (380        | ) 4,700   |   |
| Charge-offs                                 | (2,161                                       | ) 0                       | 0          | 0        | 0           | (2,161    | ) |
| Recoveries                                  | 0                                            | 0                         | 0          | 0        | 0           | 0         |   |
| Ending balance,<br>September 30             | 3,799                                        | 744                       | 2,894      | 3,041    | 63          | 10,541    |   |
| Total credit allowance                      | \$21,075                                     | \$41,857                  | \$45,505   | \$28,261 | \$12,541    | \$149,239 |   |
| 2012 year to date                           |                                              |                           |            |          |             |           |   |
| Allowance for loan losses:                  |                                              |                           |            |          |             |           |   |
| Beginning balance,<br>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,<br>September 30             | 10,748                                       | 57,178                    | 41,515     | 19,992   | 24,846      | 154,279   |   |
| Reserve for unfunded<br>credit commitments: |                                              |                           |            |          |             |           |   |
| Beginning balance,<br>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,<br>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 |   |

In establishing the allowance for loan losses, Sterling groups its loan portfolio into classes of loans collectively evaluated for impairment. 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 estimated inherent loss rate. This calculated estimated loss for each loan class is compared to the actual one-year and three-year (annualized) losses. Sterling evaluates the results of this analysis, and based on qualitative factors, one of the three loss rates may be used to better reflect the inherent losses for those loan classes.



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If a loan is determined to be impaired, Sterling prepares an individual evaluation of the loan. The individual evaluation compares the present value of 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 would 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 - the asset is considered of sufficient quality to preclude a Marginal 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.

Marginal - the asset is susceptible to deterioration if stressed from a cash flow or earnings shock, with liquidity and leverage possibly below industry norms. The borrower may have few reserves to cover debt service, besides current income. A business generating cash flows that service the debt may be dependent on the successful reception of new products in the marketplace.

Special Mention - the 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 of 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 - the 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 - the 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 the portion of the asset that 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.

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

|                       | Commercial Real Estate     |                 |             |              | Commercial<br>Owner<br>Occupied<br>CRE | Commercial<br>&<br>Industrial | Consumer  | Total       | % of<br>Total |
|-----------------------|----------------------------|-----------------|-------------|--------------|----------------------------------------|-------------------------------|-----------|-------------|---------------|
|                       | Residential<br>Real Estate | Investor<br>CRE | Multifamily | Construction |                                        |                               |           |             |               |
|                       | (in thousands)             |                 |             |              |                                        |                               |           |             |               |
| September 30,<br>2013 |                            |                 |             |              |                                        |                               |           |             |               |
| Pass                  | \$968,158                  | \$580,017       | \$1,940,743 | \$17,017     | \$727,604                              | \$450,283                     | \$780,264 | \$5,464,086 | 76 %          |
| Marginal              | 53,331                     | 448,165         | 76,840      | 30,515       | 571,100                                | 192,527                       | 15,689    | 1,388,167   | 19 %          |
| Special<br>mention    | 8,816                      | 71,575          | 10,894      | 1,159        | 63,805                                 | 20,792                        | 6,103     | 183,144     | 3 %           |
| Substandard           | 21,789                     | 24,428          | 1,343       | 4,086        | 39,349                                 | 18,061                        | 5,908     | 114,964     | 2 %           |
| Doubtful/Loss         | 287                        | 1,292           | 0           | 152          | 2,148                                  | 3                             | 0         | 3,882       | 0 %           |
| Total                 | \$1,052,381                | \$1,125,477     | \$2,029,820 | \$52,929     | \$1,404,006                            | \$681,666                     | \$807,964 | \$7,154,243 | 100 %         |
| Restructured          | \$22,153                   | \$7,351         | \$1,216     | \$2,101      | \$19,035                               | \$678                         | \$22      | \$52,556    | 1 %           |
| Nonaccrual            | 15,657                     | 16,669          | 357         | 3,588        | 22,434                                 | 2,043                         | 4,662     | 65,410      | 1 %           |
| Nonperforming         | 37,810                     | 24,020          | 1,573       | 5,689        | 41,469                                 | 2,721                         | 4,684     | 117,966     | 2 %           |
| Performing            | 1,014,571                  | 1,101,457       | 2,028,247   | 47,240       | 1,362,537                              | 678,945                       | 803,280   | 7,036,277   | 98 %          |
| Total                 | \$1,052,381                | \$1,125,477     | \$2,029,820 | \$52,929     | \$1,404,006                            | \$681,666                     | \$807,964 | \$7,154,243 | 100 %         |
| December 31,<br>2012  |                            |                 |             |              |                                        |                               |           |             |               |
| Pass                  | \$714,346                  | \$599,660       | \$1,486,824 | \$10,946     | \$678,916                              | \$349,674                     | \$723,698 | \$4,564,064 | 73 %          |
| Marginal              | 53,722                     | 472,801         | 74,379      | 42,518       | 454,348                                | 146,554                       | 17,255    | 1,261,577   | 20 %          |
| Special<br>mention    | 11,739                     | 77,342          | 10,122      | 3,401        | 85,228                                 | 38,874                        | 4,864     | 231,570     | 4 %           |
| Substandard           | 26,550                     | 67,347          | 8,745       | 17,534       | 53,183                                 | 5,397                         | 8,804     | 187,560     | 3 %           |
| Doubtful/Loss         | 365                        | 2,697           | 219         | 266          | 4,916                                  | 0                             | 0         | 8,463       | 0 %           |
| Total                 | \$806,722                  | \$1,219,847     | \$1,580,289 | \$74,665     | \$1,276,591                            | \$540,499                     | \$754,621 | \$6,253,234 | 100 %         |
| Restructured          | \$22,968                   | \$4,334         | \$4,094     | \$8,551      | \$23,152                               | \$810                         | \$307     | \$64,216    | 1 %           |
| Nonaccrual            | 20,457                     | 46,399          | 4,055       | 8,144        | 31,696                                 | 3,424                         | 6,938     | 121,113     | 2 %           |
| Nonperforming         | 43,425                     | 50,733          | 8,149       | 16,695       | 54,848                                 | 4,234                         | 7,245     | 185,329     | 3 %           |
| Performing            | 763,297                    | 1,169,114       | 1,572,140   | 57,970       | 1,221,743                              | 536,265                       | 747,376   | 6,067,905   | 97 %          |
| Total                 | \$806,722                  | \$1,219,847     | \$1,580,289 | \$74,665     | \$1,276,591                            | \$540,499                     | \$754,621 | \$6,253,234 | 100 %         |

Purchased credit impaired loans of \$6.8 million as of September 30, 2013, and \$2.1 million as of December 31, 2012, are included in the nonaccrual loans.



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Aging by class for Sterling's loan portfolio as of September 30, 2013 and December 31, 2012 was as follows:

|                                    | Commercial Real Estate     |                 |             |              | Commercial<br>Owner<br>Occupied<br>CRE | Commercial<br>&<br>Industrial | Consumer  | Total       | % of<br>Total |   |
|------------------------------------|----------------------------|-----------------|-------------|--------------|----------------------------------------|-------------------------------|-----------|-------------|---------------|---|
|                                    | Residential<br>Real Estate | Investor<br>CRE | Multifamily | Construction |                                        |                               |           |             |               |   |
|                                    | (in thousands)             |                 |             |              |                                        |                               |           |             |               |   |
| September 30,<br>2013              |                            |                 |             |              |                                        |                               |           |             |               |   |
| 30 - 59 days<br>past due           | \$2,824                    | \$7,522         | \$0         | \$602        | \$8,764                                | \$1,567                       | \$4,160   | \$25,439    | 0             | % |
| 60 - 89 days<br>past due           | 1,719                      | 1,786           | 0           | 0            | 3,174                                  | 826                           | 1,494     | 8,999       | 0             | % |
| 90 days or<br>more past due        | 15,131                     | 5,715           | 222         | 3,588        | 13,046                                 | 1,557                         | 3,807     | 43,066      | 1             | % |
| Total past due                     | 19,674                     | 15,023          | 222         | 4,190        | 24,984                                 | 3,950                         | 9,461     | 77,504      | 1             | % |
| Current                            | 1,032,707                  | 1,110,454       | 2,029,598   | 48,739       | 1,379,022                              | 677,716                       | 798,503   | 7,076,739   | 99            | % |
| Total Loans                        | \$1,052,381                | \$1,125,477     | \$2,029,820 | \$52,929     | \$1,404,006                            | \$681,666                     | \$807,964 | \$7,154,243 | 100           | % |
| 90 days or<br>more and<br>accruing | \$0                        | \$0             | \$0         | \$0          | \$0                                    | \$0                           | \$0       | \$0         | 0             | % |
| December 31,<br>2012               |                            |                 |             |              |                                        |                               |           |             |               |   |
| 30 - 59 days<br>past due           | \$5,800                    | \$10,565        | \$707       | \$611        | \$10,543                               | \$2,690                       | \$4,028   | \$34,944    | 1             | % |
| 60 - 89 days<br>past due           | 1,576                      | 1,042           | 479         | 0            | 3,300                                  | 376                           | 1,796     | 8,569       | 0             | % |
| 90 days or<br>more past due        | 20,507                     | 34,196          | 3,436       | 8,243        | 20,883                                 | 1,954                         | 4,717     | 93,936      | 2             | % |
| Total past due                     | 27,883                     | 45,803          | 4,622       | 8,854        | 34,726                                 | 5,020                         | 10,541    | 137,449     | 3             | % |
| Current                            | 778,839                    | 1,174,044       | 1,575,667   | 65,811       | 1,241,865                              | 535,479                       | 744,080   | 6,115,785   | 97            | % |
| Total Loans                        | \$806,722                  | \$1,219,847     | \$1,580,289 | \$74,665     | \$1,276,591                            | \$540,499                     | \$754,621 | \$6,253,234 | 100           | % |
| 90 days or<br>more and<br>accruing | \$0                        | \$0             | \$0         | \$0          | \$0                                    | \$0                           | \$0       | \$0         | 0             | % |

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Sterling considers its nonperforming loans to be impaired loans. The following table summarizes impaired loans by class as of September 30, 2013 and December 31, 2012:

|                         | Unpaid<br>Principal<br>Balance<br>(in thousands) | Charge-Offs | Book Balance<br>Without<br>Specific<br>Reserve | With<br>Specific<br>Reserve | Specific<br>Reserve |
|-------------------------|--------------------------------------------------|-------------|------------------------------------------------|-----------------------------|---------------------|
| September 30, 2013      |                                                  |             |                                                |                             |                     |
| Residential real estate | \$42,761                                         | \$4,951     | \$37,523                                       | \$287                       | \$287               |
| CRE:                    |                                                  |             |                                                |                             |                     |
| Investor CRE            | 28,274                                           | 4,254       | 18,956                                         | 5,064                       | 1,292               |
| Multifamily             | 2,310                                            | 737         | 1,573                                          | 0                           | 0                   |
| Construction            | 17,643                                           | 11,954      | 5,226                                          | 463                         | 152                 |
| Total CRE               | 48,227                                           | 16,945      | 25,755                                         | 5,527                       | 1,444               |
| Commercial:             |                                                  |             |                                                |                             |                     |
| Owner Occupied CRE      | 46,212                                           | 4,743       | 26,377                                         | 15,092                      | 3,169               |
| C&I                     | 14,677                                           | 11,956      | 2,721                                          | 0                           | 0                   |
| Total commercial        | 60,889                                           | 16,699      | 29,098                                         | 15,092                      | 3,169               |
| Consumer                | 4,921                                            | 237         | 4,684                                          | 0                           | 0                   |
| Total                   | \$156,798                                        | \$38,832    | \$97,060                                       | \$20,906                    | \$4,900             |
|                         | Unpaid<br>Principal<br>Balance<br>(in thousands) | Charge-Offs | Book Balance<br>Without<br>Specific<br>Reserve | With<br>Specific<br>Reserve | Specific<br>Reserve |
| December 31, 2012       |                                                  |             |                                                |                             |                     |
| Residential real estate | \$49,816                                         | \$6,391     | \$43,060                                       | \$365                       | \$365               |
| CRE:                    |                                                  |             |                                                |                             |                     |
| Investor CRE            | 59,099                                           | 8,366       | 33,540                                         | 17,193                      | 2,697               |
| Multifamily             | 9,554                                            | 1,405       | 6,873                                          | 1,276                       | 219                 |
| Construction            | 31,040                                           | 14,345      | 15,421                                         | 1,274                       | 266                 |
| Total CRE               | 99,693                                           | 24,116      | 55,834                                         | 19,743                      | 3,182               |
| Commercial:             |                                                  |             |                                                |                             |                     |
| Owner Occupied CRE      | 61,300                                           | 6,452       | 42,075                                         | 12,773                      | 4,916               |
| C&I                     | 16,959                                           | 12,725      | 4,234                                          | 0                           | 0                   |
| Total commercial        | 78,259                                           | 19,177      | 46,309                                         | 12,773                      | 4,916               |
| Consumer                | 7,671                                            | 426         | 7,245                                          | 0                           | 0                   |
| Total                   | \$235,439                                        | \$50,110    | \$152,448                                      | \$32,881                    | \$8,463             |

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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, |                            |                      |                            |
|-------------------------|----------------------------------|----------------------------|----------------------|----------------------------|
|                         | 2013                             |                            | 2012                 |                            |
|                         | Average Book Balance             | Interest Income Recognized | Average Book Balance | Interest Income Recognized |
|                         | (in thousands)                   |                            |                      |                            |
| Residential real estate | \$39,152                         | \$129                      | \$43,393             | \$170                      |
| Investor CRE            | 24,646                           | 147                        | 63,746               | 278                        |
| Multifamily             | 1,819                            | 22                         | 17,865               | 55                         |
| Construction            | 10,276                           | 60                         | 30,152               | 692                        |
| Owner Occupied CRE      | 46,263                           | 184                        | 68,270               | 316                        |
| C&I                     | 3,242                            | 13                         | 10,137               | 51                         |
| Consumer                | 4,949                            | 0                          | 5,327                | 4                          |
| Total                   | \$130,347                        | \$555                      | \$238,890            | \$1,566                    |
|                         | Nine Months Ended September 30,  |                            |                      |                            |
|                         | 2013                             |                            | 2012                 |                            |
|                         | Average Book Balance             | Interest Income Recognized | Average Book Balance | Interest Income Recognized |
|                         | (in thousands)                   |                            |                      |                            |
| Residential real estate | \$40,618                         | \$446                      | \$43,065             | \$588                      |
| Investor CRE            | 37,376                           | 603                        | 52,656               | 1,281                      |
| Multifamily             | 4,860                            | 61                         | 7,544                | 405                        |
| Construction            | 11,192                           | 2,231                      | 61,340               | 1,565                      |
| Owner Occupied CRE      | 48,159                           | 773                        | 68,353               | 1,722                      |
| C&I                     | 3,478                            | 71                         | 10,895               | 86                         |
| Consumer                | 5,965                            | 5                          | 5,947                | 4                          |
| Total                   | \$151,648                        | \$4,190                    | \$249,800            | \$5,651                    |

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The following tables present loans that were modified and recorded as troubled debt restructurings ("TDR's") during the following periods:

|                         | Three Months Ended September 30,<br>2013   |                                            |                                             | 2012                   |                                            |                                             |
|-------------------------|--------------------------------------------|--------------------------------------------|---------------------------------------------|------------------------|--------------------------------------------|---------------------------------------------|
|                         | Number of<br>Contracts                     | Pre-Modification<br>Recorded<br>Investment | Post-Modification<br>Recorded<br>Investment | Number of<br>Contracts | Pre-Modification<br>Recorded<br>Investment | Post-Modification<br>Recorded<br>Investment |
|                         | (in thousands, except number of contracts) |                                            |                                             |                        |                                            |                                             |
| Residential real estate | 3                                          | \$ 496                                     | \$ 513                                      | 15                     | \$ 2,817                                   | \$ 2,765                                    |
| Investor CRE            | 0                                          | 0                                          | 0                                           | 0                      | 0                                          | 0                                           |
| Multifamily             | 0                                          | 0                                          | 0                                           | 0                      | 0                                          | 0                                           |
| Construction            | 0                                          | 0                                          | 0                                           | 2                      | 4,118                                      | 3,241                                       |
| Owner Occupied CRE      | 0                                          | 0                                          | 0                                           | 1                      | 133                                        | 125                                         |
| C&I                     | 0                                          | 0                                          | 0                                           | 0                      | 0                                          | 0                                           |
| Consumer                | 0                                          | 0                                          | 0                                           | 1                      | 172                                        | 173                                         |
| Total <sup>(1)</sup>    | 3                                          | \$ 496                                     | \$ 513                                      | 19                     | \$ 7,240                                   | \$ 6,304                                    |

|                         | Nine Months Ended September 30,<br>2013    |                                            |                                             | 2012                   |                                            |                                             |
|-------------------------|--------------------------------------------|--------------------------------------------|---------------------------------------------|------------------------|--------------------------------------------|---------------------------------------------|
|                         | Number of<br>Contracts                     | Pre-Modification<br>Recorded<br>Investment | Post-Modification<br>Recorded<br>Investment | Number of<br>Contracts | Pre-Modification<br>Recorded<br>Investment | Post-Modification<br>Recorded<br>Investment |
|                         | (in thousands, except number of contracts) |                                            |                                             |                        |                                            |                                             |
| Residential real estate | 13                                         | \$ 2,814                                   | \$ 2,628                                    | 27                     | \$ 5,051                                   | \$ 4,993                                    |
| Investor CRE            | 4                                          | 1,745                                      | 1,442                                       | 1                      | 1,302                                      | 1,302                                       |
| Multifamily             | 0                                          | 0                                          | 0                                           | 2                      | 2,379                                      | 2,374                                       |
| Construction            | 0                                          | 0                                          | 0                                           | 4                      | 10,062                                     | 9,194                                       |
| Owner Occupied CRE      | 7                                          | 4,048                                      | 3,173                                       | 10                     | 15,574                                     | 15,515                                      |
| C&I                     | 4                                          | 449                                        | 454                                         | 9                      | 3,482                                      | 2,206                                       |
| Consumer                | 0                                          | 0                                          | 0                                           | 3                      | 468                                        | 472                                         |
| Total <sup>(1)</sup>    | 28                                         | \$ 9,056                                   | \$ 7,697                                    | 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, 2013, Sterling had specific reserves of \$591,000 on TDRs which were restructured during the previous nine months. There were 10 loans totaling \$5.9 million that were removed from TDR status during the three months ended September 30, 2013, as they had met the conditions for removal by achieving twelve consecutive months of performance at market equivalent rates of interest.

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The following table shows the post-modification recorded investment by class for TDRs restructured during the periods presented by the primary type of concession granted:

|                                      | Principal<br>Deferral | Rate<br>Reduction | Extension of<br>Terms | Forgiveness<br>of Principal<br>and/or<br>Interest | Total    |
|--------------------------------------|-----------------------|-------------------|-----------------------|---------------------------------------------------|----------|
| Nine Months Ended September 30, 2013 | (in thousands)        |                   |                       |                                                   |          |
| Residential Real Estate              | \$0                   | \$2,094           | \$203                 | \$331                                             | \$2,628  |
| Investor CRE                         | 262                   | 1,139             | 0                     | 41                                                | 1,442    |
| Multifamily                          | 0                     | 0                 | 0                     | 0                                                 | 0        |
| Construction                         | 0                     | 0                 | 0                     | 0                                                 | 0        |
| Owner CRE                            | 1,365                 | 1,684             | 124                   | 0                                                 | 3,173    |
| C&I                                  | 447                   | 0                 | 7                     | 0                                                 | 454      |
| Consumer                             | 0                     | 0                 | 0                     | 0                                                 | 0        |
| Total                                | \$2,074               | \$4,917           | \$334                 | \$372                                             | \$7,697  |
| Nine Months Ended September 30, 2012 |                       |                   |                       |                                                   |          |
| 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      |
| Total                                | \$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, 2013 that subsequently defaulted during the period.

During the three months ended September 30, 2013 and 2012, \$3.8 million and \$4.5 million, respectively, of TDRs were returned to accrual status, and during the nine month periods ended September 30, 2013 and 2012, \$8.1 million and \$9.8 million, respectively, of TDRs were returned to accrual status. The following table outlines accrual status of TDRs as of the dates shown:

|                           | September 30,<br>2013 | December 31,<br>2012 |
|---------------------------|-----------------------|----------------------|
|                           | (in thousands)        |                      |
| TDRs on nonaccrual status | \$14,640              | \$19,510             |
| TDRs on accrual status    | 37,916                | 44,706               |
| Total TDRs                | \$52,556              | \$64,216             |

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## 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:

|                              | 2013<br>(in thousands) | 2012     |
|------------------------------|------------------------|----------|
| Beginning balance, January 1 | \$22,577               | \$0      |
| Additions                    | 14,056                 | 22,577   |
| Ending balance, September 30 | \$36,633               | \$22,577 |

Additions to goodwill during the nine months ended September 30, 2013 and the year ended December 31, 2012 have 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, 2013 and December 31, 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<br>(in thousands) | Accumulated<br>Amortization | Net Carrying Amount |
|--------------------------|-----------------------------------------|-----------------------------|---------------------|
| September 30, 2013       |                                         |                             |                     |
| Core deposit intangibles | \$57,547                                | \$42,943                    | \$14,604            |
| Other                    | 1,800                                   | 250                         | 1,550               |
|                          | \$59,347                                | \$43,193                    | \$16,154            |
| December 31, 2012        |                                         |                             |                     |
| Core deposit intangibles | \$55,420                                | \$38,029                    | \$17,391            |
| Other                    | 1,800                                   | 119                         | 1,681               |
|                          | \$57,220                                | \$38,148                    | \$19,072            |

Projected amortization expense over the following periods for existing core deposit and other intangibles recorded as of September 30, 2013 was:

|                          | Amount  |
|--------------------------|---------|
| Remainder of 2013        | \$1,793 |
| Years ended December 31, |         |
| 2014                     | 3,669   |
| 2015                     | 2,628   |
| 2016                     | 1,486   |
| 2017                     | 1,352   |
| 2018                     | 1,236   |

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## 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, 2013, all of Sterling's junior subordinated debentures were redeemable at par, at their applicable quarterly or semiannual interest payment dates.

Details of the junior subordinated debentures as of September 30, 2013 are as follows:

| Subsidiary Issuer                     | Issue Date | Maturity Date | Next Interest Payment Date | Rate  | Amount<br>(in thousands) |
|---------------------------------------|------------|---------------|----------------------------|-------|--------------------------|
| Sterling Capital Trust IX             | July 2007  | Oct 2037      | Oct 2013                   | 1.67% | \$46,392                 |
| Sterling Capital Trust VIII           | Sept 2006  | Dec 2036      | Dec 2013                   | 1.88  | 51,547                   |
| Sterling Capital Trust VII            | June 2006  | June 2036     | Dec 2013                   | 1.78  | 56,702                   |
| Lynnwood Financial Statutory Trust II | June 2005  | June 2035     | Dec 2013                   | 2.05  | 10,310                   |
| Sterling Capital Trust VI             | June 2003  | Sept 2033     | Dec 2013                   | 3.45  | 10,310                   |
| Sterling Capital Statutory Trust V    | May 2003   | June 2033     | Dec 2013                   | 3.50  | 20,619                   |
| Sterling Capital Trust IV             | May 2003   | May 2033      | Nov 2013                   | 3.41  | 10,310                   |
| Sterling Capital Trust III            | April 2003 | April 2033    | Oct 2013                   | 3.52  | 14,433                   |
| Lynnwood Financial Statutory Trust I  | Mar 2003   | Mar 2033      | Dec 2013                   | 3.40  | 9,430                    |
| Klamath First Capital Trust I         | July 2001  | July 2031     | Jan 2014                   | 4.15  | 15,245                   |
|                                       |            |               |                            | 2.39% | * \$245,298              |

\* Weighted average rate.

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## 7. Earnings Per Share:

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

|                                                            | Three Months Ended<br>September 30,                 |            | Nine Months Ended September<br>30, |            |
|------------------------------------------------------------|-----------------------------------------------------|------------|------------------------------------|------------|
|                                                            | 2013                                                | 2012       | 2013                               | 2012       |
|                                                            | (in thousands, except shares and per share amounts) |            |                                    |            |
| Numerator:                                                 |                                                     |            |                                    |            |
| Net income                                                 | \$21,048                                            | \$30,598   | \$71,487                           | \$364,775  |
| Denominator:                                               |                                                     |            |                                    |            |
| Weighted average shares outstanding - basic                | 62,309,270                                          | 62,139,833 | 62,280,542                         | 62,110,498 |
| Dilutive securities outstanding                            | 1,151,748                                           | 706,031    | 990,518                            | 634,679    |
| Weighted average shares outstanding - diluted              | 63,461,018                                          | 62,845,864 | 63,271,060                         | 62,745,177 |
| Earnings per share - basic                                 | \$0.34                                              | \$0.49     | \$1.15                             | \$5.87     |
| Earnings per share - diluted                               | \$0.33                                              | \$0.49     | \$1.13                             | \$5.81     |
| Antidilutive securities outstanding (weighted<br>average): |                                                     |            |                                    |            |
| Stock options                                              | 359                                                 | 13,054     | 6,445                              | 14,174     |
| Restricted shares                                          | 0                                                   | 0          | 1,067                              | 9,249      |
| Total antidilutive securities outstanding                  | 359                                                 | 13,054     | 7,512                              | 23,423     |

Sterling's dilutive securities outstanding include warrants held by certain investors. As of September 30, 2013, there were 2,874,594 warrants outstanding, with an exercise price of \$13.26. As of December 31, 2012, there were 2,749,044 warrants outstanding, with an exercise price of \$13.86. These warrants were issued as part of the 2010 recapitalization, and have an expiration date of August 26, 2017. Adjustments to the number and exercise price of these outstanding warrants occurred due to dividend distributions triggering an anti-dilutive provision.

## 8. Noninterest Expense:

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

|                                         | Three Months Ended<br>September 30, |          | Nine Months Ended September<br>30, |           |
|-----------------------------------------|-------------------------------------|----------|------------------------------------|-----------|
|                                         | 2013                                | 2012     | 2013                               | 2012      |
|                                         | (in thousands)                      |          |                                    |           |
| Employee compensation and benefits      | \$47,058                            | \$45,636 | \$135,297                          | \$139,502 |
| Occupancy and equipment                 | 9,959                               | 11,034   | 29,385                             | 32,253    |
| Data processing                         | 7,252                               | 7,137    | 20,300                             | 20,600    |
| Professional fees                       | 3,093                               | 4,929    | 12,030                             | 12,718    |
| Depreciation                            | 3,358                               | 2,918    | 9,350                              | 8,754     |
| Merger and acquisition                  | 3,896                               | 1,584    | 7,200                              | 9,981     |
| OREO operations                         | 1,877                               | 4,008    | 6,456                              | 9,337     |
| Advertising                             | 1,830                               | 3,442    | 6,025                              | 10,370    |
| Amortization of other intangible assets | 1,676                               | 1,792    | 5,046                              | 4,988     |
| FDIC insurance                          | 1,129                               | 2,159    | 4,693                              | 6,005     |
| Travel and entertainment                | 1,467                               | 1,420    | 4,151                              | 4,019     |
| Other                                   | 2,739                               | 3,349    | 9,008                              | 7,137     |
| Total noninterest expense               | \$85,334                            | \$89,408 | \$248,941                          | \$265,664 |





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## 9. Income Taxes:

During the three months ended September 30, 2013, Sterling recognized income tax expense of \$8.1 million, reflecting a 28% effective tax rate, and during the nine months ended September 30, 2013, income tax expense of \$30.9 million, reflecting a 30% effective tax rate. The nine month comparable 2012 period included an income tax benefit of \$288.8 million, the result of reversing substantially all of Sterling's deferred tax asset valuation allowance. The effective tax rates for the 2013 periods reflect permanent differences between book income and tax income from the Borrego acquisition bargain purchase gain, as well as tax exempt municipal bond and BOLI income. As of September 30, 2013, the net deferred tax asset was \$282.6 million, including \$245.3 million of net operating loss and tax credit carry-forwards, compared with \$292.1 million as of December 31, 2012, including \$274.0 million of net operating loss and tax credit carry-forwards.

## 10. Stock Based Compensation:

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

|                                 | Shares  | Weighted<br>Average<br>Grant Price |
|---------------------------------|---------|------------------------------------|
| Balance, January 1, 2013        | 385,513 | \$19.16                            |
| Granted                         | 245,970 | 22.05                              |
| Vested                          | (96,077 | ) 19.50                            |
| Forfeited                       | (8,473  | ) 19.15                            |
| Outstanding, September 30, 2013 | 526,933 | \$20.45                            |

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

|                                 | Shares  | Weighted<br>Average<br>Exercise<br>Price |
|---------------------------------|---------|------------------------------------------|
| Balance, January 1, 2013        | 12,399  | \$1,433.63                               |
| Granted                         | 245,847 | 21.69                                    |
| Exercised                       | 0       | 0.00                                     |
| Expired                         | (5,524  | ) 1,833.61                               |
| Cancelled                       | (96     | ) 1,337.16                               |
| Outstanding, September 30, 2013 | 252,626 | \$50.87                                  |
| Exercisable, September 30, 2013 | 42,040  | \$196.85                                 |

The Black-Scholes option-pricing model was used in estimating the fair value of option grants. The weighted average assumptions used during the period were:

|                          | Nine Months Ended September 30, 2013 |   |
|--------------------------|--------------------------------------|---|
| Expected volatility      | 40                                   | % |
| Expected term (in years) | 8.4                                  |   |
| Expected dividend yield  | 3.28                                 | % |
| Risk free interest rate  | 1.55                                 | % |

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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<br>Outstanding<br>Weighted<br>Average Life<br>(dollars in thousands) | Intrinsic<br>Value | Exercisable<br>Weighted<br>Average Life | Intrinsic<br>Value |
|--------------------|------------------------------------------------------------------------------------|--------------------|-----------------------------------------|--------------------|
| September 30, 2013 | 9.2 years                                                                          | \$1,711            | 8.0 years                               | \$253              |
| December 31, 2012  | 1.3 years                                                                          | 0                  | 1.2 years                               | 0                  |

As of September 30, 2013, a total of 4,912,174 shares remained available for grant under Sterling's 2007 and 2010 Long-Term Incentive Plans. The stock options outstanding under these plans have terms of six and 10 years. Stock based compensation expense recognized during the periods presented was as follows:

|                  | Three Months Ended September 30, |       | Nine Months Ended September 30, |         |
|------------------|----------------------------------|-------|---------------------------------|---------|
|                  | 2013                             | 2012  | 2013                            | 2012    |
|                  | (in thousands)                   |       |                                 |         |
| Stock options    | \$196                            | \$6   | \$491                           | \$37    |
| Restricted stock | 1,141                            | 907   | 3,167                           | 2,719   |
| Total            | \$1,337                          | \$913 | \$3,658                         | \$2,756 |

As of September 30, 2013, unrecognized equity compensation expense totaled \$8.6 million as the underlying outstanding awards had not yet been earned. This amount will be recognized over a weighted average period of 2.6 years.

#### 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 fair value of interest rate lock commitments presented in the table below has been adjusted to reflect the expected 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").

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Residential mortgage loans held for sale that were not committed to investors were \$173.7 million and \$419.1 million as of September 30, 2013 and December 31, 2012, respectively. The following table summarizes Sterling's mortgage banking operations and interest rate swaps:

|                                     | September 30, 2013         |                     |           |
|-------------------------------------|----------------------------|---------------------|-----------|
|                                     | Notional<br>(in thousands) | Fair Value<br>Asset | Liability |
| Interest rate lock commitments, net | \$174,204                  | \$6,423             | \$0       |
| Forward commitments                 | 288,000                    | 0                   | 5,208     |
| Interest rate swaps - broker-dealer | 25,152                     | 0                   | 1,028     |
| Interest rate swaps - customer      | 26,190                     | 1,020               | 0         |
|                                     | December 31, 2012          |                     |           |
|                                     | Notional<br>(in thousands) | Fair Value<br>Asset | Liability |
| Interest rate lock commitments, net | \$242,061                  | \$9,035             | \$0       |
| Forward commitments                 | 531,000                    | 0                   | 1,881     |
| Interest rate swaps - broker-dealer | 44,846                     | 0                   | 2,144     |
| Interest rate swaps - customer      | 36,158                     | 2,148               | 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, |           |
|-----------------------------|----------------------------------|-----------|---------------------------------|-----------|
|                             | 2013                             | 2012      | 2013                            | 2012      |
|                             | (in thousands)                   |           |                                 |           |
| Mortgage banking operations | \$12,245                         | \$(2,694) | ) \$4,881                       | \$(3,349) |
| Other noninterest income    | 1                                | 80        | 127                             | (600)     |

Also included in mortgage banking income were loan servicing fees income of \$1.5 million and a loss of \$2.1 million for the three months ended September 30, 2013 and 2012, respectively, and income of \$8.3 million and a loss of \$183,000 for the nine months ended September 30, 2013 and 2012, respectively.

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## 12. Offsetting Assets and Liabilities:

Certain derivatives and repurchase agreements are subject to net settlement. Depending on the governing disclosure rules or elections made by management, amounts are presented gross or net on a balance sheet. The following summarizes the presentation of Sterling's interest rate swaps and securities sold under repurchase agreements, all of which are presented gross on Sterling's balance sheet:

|                                                | Amount<br>Recognized | Amount Offset<br>on Balance<br>Sheet | Amount<br>Presented on<br>Balance Sheet | Pledged Collateral on<br>Balance Sheet |         | Net<br>Position |
|------------------------------------------------|----------------------|--------------------------------------|-----------------------------------------|----------------------------------------|---------|-----------------|
|                                                |                      |                                      |                                         | Securities                             | Cash    |                 |
| September 30, 2013                             | (in thousands)       |                                      |                                         |                                        |         |                 |
| Assets                                         |                      |                                      |                                         |                                        |         |                 |
| Interest rate swaps                            | \$1,020              | \$0                                  | \$1,020                                 | \$0                                    | \$0     | \$1,020         |
| Total                                          | \$1,020              | \$0                                  | \$1,020                                 | \$0                                    | \$0     | \$1,020         |
| Liabilities                                    |                      |                                      |                                         |                                        |         |                 |
| Securities sold under<br>repurchase agreements | \$534,669            | \$0                                  | \$534,669                               | \$534,669                              | \$0     | \$0             |
| Interest rate swaps                            | 1,028                | 0                                    | 1,028                                   | 0                                      | 1,028   | 0               |
| Total                                          | \$535,697            | \$0                                  | \$535,697                               | \$534,669                              | \$1,028 | \$0             |
| December 31, 2012                              |                      |                                      |                                         |                                        |         |                 |
| Assets                                         |                      |                                      |                                         |                                        |         |                 |
| Interest rate swaps                            | \$2,148              | \$0                                  | \$2,148                                 | \$0                                    | \$0     | \$2,148         |
| Total                                          | \$2,148              | \$0                                  | \$2,148                                 | \$0                                    | \$0     | \$2,148         |
| Liabilities                                    |                      |                                      |                                         |                                        |         |                 |
| Securities sold under<br>repurchase agreements | \$586,867            | \$0                                  | \$586,867                               | \$586,867                              | \$0     | \$0             |
| Interest rate swaps                            | 2,144                | 0                                    | 2,144                                   | 0                                      | 2,144   | 0               |
| Total                                          | \$589,011            | \$0                                  | \$589,011                               | \$586,867                              | \$2,144 | \$0             |

Sterling's cash, and investments and MBS included cash and securities pledged against its interest rate swap and securities sold under repurchase agreements liabilities.

## 13. 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.

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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, 2013 |            | December 31, 2012 |            |
|---------------------------------|-------|--------------------|------------|-------------------|------------|
|                                 |       | Carrying Amount    | Fair Value | Carrying Amount   | Fair Value |
| Financial assets:               |       |                    |            |                   |            |
| Cash and cash equivalents       | 1     | \$349,679          | \$349,679  | \$331,550         | \$331,550  |
| Investments and MBS:            |       |                    |            |                   |            |
| Available for sale              | 2     | 1,498,377          | 1,498,377  | 1,513,157         | 1,513,157  |
| Held to maturity                | 2     | 175                | 175        | 206               | 206        |
| Loans held for sale             | 2     | 245,783            | 246,307    | 465,983           | 465,983    |
| Loans receivable, net           | 3     | 7,024,326          | 7,058,375  | 6,101,749         | 6,154,296  |
| Mortgage servicing rights, net  | 3     | 57,030             | 68,919     | 32,420            | 32,420     |
| Other assets (1)                | 2     | 102,602            | 102,602    | 108,642           | 108,642    |
| Financial liabilities:          |       |                    |            |                   |            |
| Non-maturity deposits           | 2     | 5,111,524          | 5,111,524  | 4,697,147         | 4,697,147  |
| Deposits with stated maturities | 2     | 1,742,918          | 1,760,718  | 1,738,970         | 1,768,818  |
| Borrowings                      | 2     | 1,807,774          | 1,734,432  | 1,437,491         | 1,457,911  |
| Other liabilities               | 2     | 6,236              | 6,236      | 4,025             | 4,025      |

(1) Other assets includes FHLB stock. As of September 30, 2013 and December 31, 2012, FHLB stock was carried at \$95.2 million and \$97.5 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.

**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

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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. Certain residential mortgage loans that were previously classified as held for sale are carried at fair value because at origination Sterling elected to carry these loans at fair value. The fair value of these loans is based on current market rates with various discounts applied to each individual loan. 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, among other factors, prepayment speeds, market interest rates, contractual interest rates on the loans being serviced, and the amount of other fee income generated. 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.** Valuations of interest rate lock commitments and forward commitments 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.



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## 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<br>(in thousands) | Level 1 | Level 2     | Level 3  |
|------------------------------------------------|-------------------------|---------|-------------|----------|
| September 30, 2013                             |                         |         |             |          |
| Investment securities available for sale:      |                         |         |             |          |
| MBS                                            | \$1,305,456             | \$0     | \$1,305,456 | \$0      |
| Municipal bonds                                | 192,749                 | 0       | 192,749     | 0        |
| Other                                          | 172                     | 0       | 172         | 0        |
| Total investment securities available for sale | 1,498,377               | 0       | 1,498,377   | 0        |
| Loans held for sale                            | 190,635                 | 0       | 190,635     | 0        |
| Loans receivable, net                          | 26,931                  | 0       | 0           | 26,931   |
| Other assets - derivatives                     | 7,443                   | 0       | 7,443       | 0        |
| Total assets                                   | \$1,723,386             | \$0     | \$1,696,455 | \$26,931 |
| Other liabilities - derivatives                | 6,236                   | 0       | 6,236       | 0        |
| Total liabilities                              | \$6,236                 | \$0     | \$6,236     | \$0      |
| December 31, 2012                              |                         |         |             |          |
| Investment securities available for sale:      |                         |         |             |          |
| MBS                                            | \$1,308,838             | \$0     | \$1,308,838 | \$0      |
| Municipal bonds                                | 204,306                 | 0       | 204,306     | 0        |
| Other                                          | 13                      | 0       | 13          | 0        |
| Total investment securities available for sale | 1,513,157               | 0       | 1,513,157   | 0        |
| Loans held for sale                            | 465,983                 | 0       | 465,983     | 0        |
| Loans receivable, net                          | 23,177                  | 0       | 0           | 23,177   |
| Other assets - derivatives                     | 11,183                  | 0       | 11,183      | 0        |
| Total assets                                   | \$2,013,500             | \$0     | \$1,990,323 | \$23,177 |
| Contingent consideration                       | \$15,442                | \$0     | \$0         | \$15,442 |
| Other liabilities - derivatives                | 4,025                   | 0       | 4,025       | 0        |
| Total liabilities                              | \$19,467                | \$0     | \$4,025     | \$15,442 |

The following table presents the changes in fair value for loans receivable measured at fair value on a recurring basis using Level 3 inputs:

|                                | Nine Months Ended September 30, |          |
|--------------------------------|---------------------------------|----------|
|                                | 2013                            | 2012     |
|                                | (in thousands)                  |          |
| Beginning balance              | \$23,177                        | \$12,776 |
| Transfers from held for sale   | 15,622                          | 12,308   |
| Principal payments and payoffs | (11,078)                        | (2,245)  |
| Valuation adjustments          | (790)                           | (379)    |
| Ending balance                 | \$26,931                        | \$22,460 |

Differences between the aggregate fair value and the aggregate unpaid principal balance of loans receivable carried at fair value were \$790,000 and \$379,000 during the nine months ended September 30, 2013 and 2012, respectively, and were included in

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income from mortgage banking operations. Valuation adjustments were based on current market rates for comparable loans, in addition to discounts applied based on specific loan characteristics.

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:

|                       | Nine Months Ended September 30, |          |
|-----------------------|---------------------------------|----------|
|                       | 2013                            | 2012     |
|                       | (in thousands)                  |          |
| Beginning balance     | \$15,442                        | \$0      |
| Additions             | 0                               | 11,779   |
| Valuation adjustments | 1,395                           | 2,272    |
| Payout                | (16,837                         | ) 0      |
| Ending balance        | \$0                             | \$14,051 |

Valuation adjustments were included in noninterest expense as merger and acquisition expenses. The final contingent consideration payment was made in the third quarter of 2013.

Derivatives include mortgage banking interest rate lock and loan delivery commitments, and interest rate swaps. See Note 11 for a further discussion of these derivatives. The differences 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, |           |
|-----------------------------|---------------------------------|-----------|
|                             | 2013                            | 2012      |
|                             | (in thousands)                  |           |
| Mortgage banking operations | \$(12,532                       | ) \$9,049 |

## 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, 2013      |         |         |           | Gains<br>(Losses) During the<br>Nine Months Ended<br>September 30, 2013 |
|---------------------------|-------------------------|---------|---------|-----------|-------------------------------------------------------------------------|
|                           | Total Carrying<br>Value | Level 1 | Level 2 | Level 3   |                                                                         |
|                           | (in thousands)          |         |         |           |                                                                         |
| Loans                     | \$76,193                | \$0     | \$0     | \$76,193  | \$(6,173 )                                                              |
| OREO                      | 10,562                  | 0       | 0       | 10,562    | (5,224 )                                                                |
| Mortgage servicing rights | 57,030                  | 0       | 0       | 57,030    | 6,105                                                                   |
|                           | December 31, 2012       |         |         |           | Losses<br>During the Year<br>Ended<br>December 31, 2012                 |
|                           | Total Carrying<br>Value | Level 1 | Level 2 | Level 3   |                                                                         |
| Loans                     | \$172,172               | \$0     | \$0     | \$172,172 | \$(27,649 )                                                             |
| OREO                      | 18,074                  | 0       | 0       | 18,074    | (1,296 )                                                                |
| Mortgage servicing rights | 32,420                  | 0       | 0       | 32,420    | (230 )                                                                  |

The loans disclosed above represent the net balance of loans as of period end that have been individually evaluated for impairment during the nine months ended September 30, 2013, and the year ended December 31, 2012, respectively, with the losses comprised of charge-offs and increases in the specific reserve. OREO represents the carrying value of properties for

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which a specific reserve was recorded 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 \$1.5 million and \$3.9 million for the nine months ended September 30, 2013 and the year ended December 31, 2012, 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, 2013                                      |                                                                                                                                                                                             |
|---------------------------|---------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                           | Method                                                  | Inputs                                                                                                                                                                                      |
| Loans                     | Income, Market, Comparable Sales, Discounted Cash Flows | 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%. |
| OREO                      | Income, Market, Comparable Sales, Discounted Cash Flows | 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: residential 10.2%, commercial 12.8%; weighted average discount rate: residential 10.2%, commercial 17.1%.                                                |

## 14. Regulatory Capital:

The following table sets forth the respective regulatory capital positions for Sterling and Sterling Bank as of September 30, 2013:

|                                 | Actual                   |       | Adequately Capitalized |       | Well-Capitalized |       |   |  |
|---------------------------------|--------------------------|-------|------------------------|-------|------------------|-------|---|--|
|                                 | Amount<br>(in thousands) | Ratio | Amount                 | Ratio | Amount           | Ratio |   |  |
| Tier 1 leverage ratio           |                          |       |                        |       |                  |       |   |  |
| Sterling                        | \$ 1,134,493             | 11.8  | % \$384,630            | 4.0   | % \$480,787      | 5.0   | % |  |
| Sterling Bank                   | 1,111,164                | 11.6  | % 384,647              | 4.0   | % 480,809        | 5.0   | % |  |
| Tier 1 risk-based capital ratio |                          |       |                        |       |                  |       |   |  |
| Sterling                        | 1,134,493                | 15.4  | % 294,609              | 4.0   | % 441,914        | 6.0   | % |  |
| Sterling Bank                   | 1,111,164                | 15.1  | % 294,691              | 4.0   | % 442,036        | 6.0   | % |  |
| Total risk-based capital ratio  |                          |       |                        |       |                  |       |   |  |
| Sterling                        | 1,227,264                | 16.7  | % 589,219              | 8.0   | % 736,523        | 10.0  | % |  |
| Sterling Bank                   | 1,204,091                | 16.3  | % 589,381              | 8.0   | % 736,727        | 10.0  | % |  |

## 15. 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 holding company-level transactions and intercompany eliminations.

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|                                   | As of and for the Three Months Ended September 30, 2013 |                       |                           |             |
|-----------------------------------|---------------------------------------------------------|-----------------------|---------------------------|-------------|
|                                   | Community<br>Banking                                    | Home Loan<br>Division | Other and<br>Eliminations | Total       |
|                                   | (in thousands)                                          |                       |                           |             |
| Interest income                   | \$89,430                                                | \$7,014               | \$0                       | \$96,444    |
| Interest expense                  | 12,427                                                  | 0                     | 1,469                     | 13,896      |
| Net interest income               | 77,003                                                  | 7,014                 | (1,469)                   | 82,548      |
| Provision for credit losses       | 0                                                       | 0                     | 0                         | 0           |
| Noninterest income                | 15,756                                                  | 16,134                | 0                         | 31,890      |
| Noninterest expense               | 64,074                                                  | 17,468                | 3,792                     | 85,334      |
| Income (loss) before income taxes | \$28,685                                                | \$5,680               | \$(5,261)                 | \$29,104    |
| Total assets                      | \$9,758,046                                             | \$200,575             | \$25,715                  | \$9,984,336 |
|                                   | As of and for the Three Months Ended September 30, 2012 |                       |                           |             |
|                                   | Community<br>Banking                                    | Home Loan<br>Division | Other and<br>Eliminations | Total       |
|                                   | (in thousands)                                          |                       |                           |             |
| 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 |
|                                   | As of and for the Nine Months Ended September 30, 2013  |                       |                           |             |
|                                   | Community<br>Banking                                    | Home Loan<br>Division | Other and<br>Eliminations | Total       |
|                                   | (in thousands)                                          |                       |                           |             |
| Interest income                   | \$259,819                                               | \$21,399              | \$0                       | \$281,218   |
| Interest expense                  | 36,988                                                  | 0                     | 4,374                     | 41,362      |
| Net interest income               | 222,831                                                 | 21,399                | (4,374)                   | 239,856     |
| Provision for credit losses       | 0                                                       | 0                     | 0                         | 0           |
| Noninterest income                | 54,757                                                  | 57,167                | (465)                     | 111,459     |
| Noninterest expense               | 182,433                                                 | 61,278                | 5,230                     | 248,941     |
| Income (loss) before income taxes | \$95,155                                                | \$17,288              | \$(10,069)                | \$102,374   |
| Total assets                      | \$9,758,046                                             | \$200,575             | \$25,715                  | \$9,984,336 |

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|                                   | As of and for the Nine Months Ended September 30, 2012 |                       |                           |             |
|-----------------------------------|--------------------------------------------------------|-----------------------|---------------------------|-------------|
|                                   | Community<br>Banking                                   | Home Loan<br>Division | Other and<br>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 |

## 16. Commitments and Contingencies:

**Merger Agreement.** On September 11, 2013, Sterling entered into a definitive agreement to merge (the "Merger") with and into Umpqua Holdings Corporation ("Umpqua"), with headquarters in Portland, Oregon. Immediately after the Merger, Sterling Savings Bank will merge (the "Bank Merger") with and into Umpqua Bank, an Oregon state chartered bank and wholly owned subsidiary of Umpqua. Upon completion of the merger, the combined company will operate under the Umpqua Bank name and brand. The transaction is expected to be completed in the first half of 2014, subject to shareholder and regulatory approval and other customary closing conditions. Under the terms of the agreement, Sterling shareholders will receive 1.671 shares of Umpqua common stock and \$2.18 cash for each share of Sterling common stock.

**Merger Litigation.** On September 18, 2013, Plaintiff Matthew Barnett filed a purported class action on behalf of Sterling's shareholders in connection with the proposed merger of Sterling and Umpqua in the Superior Court for Spokane County, Washington, docketed as Barnett v. Sterling Financial Corporation et al., No. 13-2-03848-4. On September 23, 2013, Plaintiff Vladimir Gusinsky Revocable Trust filed another purported class action in the Superior Court for Spokane County, docketed as Vladimir Gusinsky Revocable Trust v. Seibly et al., No. 13-2-03904-9. On September 26, 2013, Plaintiff Shoshana Minzer filed a third purported class action in the Superior Court for Spokane County, docketed as Minzer v. Sterling Financial Corporation et al., No. 13-2-03986-3. Each complaint names as defendants the members of Sterling's Board of Directors. The Barnett and Minzer complaints also name Sterling as a defendant. The Barnett and Gusinsky complaints also name Umpqua as a defendant.

The lawsuits allege, among other things, that the Board of Directors breached its fiduciary duties to shareholders by failing to take steps to maximize shareholder value or to engage in a fair sale process before approving the Merger. The lawsuits allege that the consideration to be paid by Umpqua is inadequate in light of Sterling's recent performance and growth potential, that Board members labored under conflicts of interest, that Sterling failed to negotiate a protective collar on the exchange ratio, and that the use of certain deal protection mechanisms precluded Sterling from investigating or pursuing alternatives or proposals superior to the Merger. Two of the lawsuits allege that Umpqua aided and abetted the Board of Director's breaches of fiduciary duty.

On October 11, 2013, the Superior Court for Spokane County consolidated the three actions as In re Sterling Financial Corporation Merger Litigation, Lead No. 13-2-03848-4, and lead counsel was appointed.

The plaintiffs in these actions seek relief that includes, among other things, an injunction prohibiting the consummation of the Merger, rescission to the extent the Merger terms have already been implemented, damages for the breaches of fiduciary duty, and the payment of plaintiffs' attorneys' fees and costs. Sterling believes the lawsuits are without merit and intends to defend against them vigorously. There can be no assurance, however, with regard to the outcome of these lawsuits. Currently, a loss resulting from these claims is not considered probable or reasonably estimable in amount.

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 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



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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. 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. On August 5, 2013, the court entered an order granting defendants' motion and dismissing the complaint in its entirety. On October 11, 2013, the lead plaintiff filed an amended consolidated complaint. The amended consolidated complaint names the same defendants, specifies the same class period, alleges the same violations of Sections 10(b) and 20(a) of the Securities & Exchange Act of 1934, and seeks the same relief. The amended consolidated complaint contains similar allegations of improper disclosure regarding Sterling's lending practices, status of loans and reserving and accounting for loans. Sterling believes the lawsuit is without merit and intends to defend against it vigorously. 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.

Additionally, Sterling is involved in ongoing litigation, primarily related to its normal business operations. When establishing a liability for contingent litigation losses, Sterling determines a range of potential losses for each matter that is both probable and estimable, and records the amount it considers to be the best estimate within the range. For these matters and others where an unfavorable outcome is reasonably possible but not probable, there is no estimable range of possible losses. Sterling believes that the eventual outcome from these cases will not, individually or in the aggregate, have a material adverse effect on its consolidated financial position.

## 17. Subsequent Event:

Commerce National Bank. On October 1, 2013, Sterling paid \$42.9 million in cash to acquire Commerce National Bank ("CNB"). The consolidated financial statements, including segment reporting, as of September 30, 2013, do not include the assets acquired and liabilities assumed as the acquisition occurred on October 1, 2013. The following table summarizes the preliminary net assets acquired amounts recorded at closing:

|                           | October 1, 2013<br>(in thousands) |
|---------------------------|-----------------------------------|
| Cash and cash equivalents | \$8,555                           |
| Investments and MBS       | 69,490                            |
| Loans receivable, net     | 161,043                           |
| Goodwill                  | 14,408                            |
| Core deposit intangible   | 1,160                             |
| Other assets              | 5,276                             |
| Total assets acquired     | \$259,932                         |
| Deposits                  | \$189,563                         |
| Advances from FHLB        | 25,000                            |
| Other liabilities         | 2,462                             |
| Total liabilities assumed | 217,025                           |
| Net assets acquired       | \$42,907                          |

The recorded goodwill represents the inherent value of the CNB transaction, as a result of the expected enhancement of Sterling's current operations in Southern California. The amount of goodwill deductible for income tax purposes is approximately equivalent to the recorded book value. The core deposit intangible has an amortization period of approximately ten years and will be amortized on an accelerated basis. The statement of assets acquired and liabilities assumed at fair value are presented above, however, additional adjustments to these amounts may be required, specifically to loans receivable, other assets, which includes OREO and deferred tax assets, and other liabilities, as

Sterling finalizes the fair value estimates.

As of October 1, 2013, the unpaid principal balance on purchased loans was \$164.2 million. Sterling estimated that \$3.7 million of these cash flows would be uncollectable, resulting in a combined credit and interest rate discount of \$3.8 million being recorded on these loans. As of the acquisition date, no material loans purchased from CNB exhibited evidence of credit deterioration.

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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 2012 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. Sterling Savings Bank does business as Sterling Bank in Washington, Oregon and Idaho, and as Argent Bank in California, offering retail and commercial banking products and services, mortgage lending and trust and investment products to individuals, small businesses, commercial organizations and corporations. As of September 30, 2013, Sterling had assets of \$9.98 billion and operated 169 depository branches in Washington, Oregon, Idaho and California.

Overview

Net income for the three and nine months ended September 30, 2013 was \$21.0 million and \$71.5 million, respectively, compared with \$30.6 million and \$364.8 million for the respective 2012 periods. The changes in operating results over the periods presented included an increase in net interest income and net interest margin, and lower credit costs. Net income for the three months ended September 30, 2013, compared with the three months ended September 30, 2012, also reflected lower mortgage banking income and an income tax provision, while the change during the nine month comparative periods primarily reflected the income tax benefit of \$288.8 million in the 2012 period from reversing substantially all of the deferred tax asset valuation allowance.

The net interest margin expanded to 3.59% and 3.66% for the three and nine months ended September 30, 2013, from 3.43% and 3.46% for the three and nine months ended September 30, 2012 respectively, driven by a decline in funding costs. The decline in funding costs reflected a shift in mix and repricing within deposits, as well as a lower balance of wholesale borrowings from securities sold under repurchase agreements. Net interest income for the three and nine months ended September 30, 2013 expanded by \$7.2 million and \$11.3 million respectively over the 2012 comparative periods, reflecting the decline in funding costs and an increase in interest income on loans, partially offset by a decline in interest income on MBS.

During the three and nine months ended September 30, 2013, there was no provision for credit losses, compared with a \$2.0 million and \$10.0 million provision during the respective 2012 periods, reflecting the decline in nonperforming assets. At September 30, 2013, nonperforming assets to total assets was 1.36% compared to 2.73% at September 30, 2012.

On February 28, 2013, Sterling completed the acquisition of American Heritage Holdings, the holding company for Borrego Springs Bank, N.A. ("Borrego"), for \$8.7 million in cash consideration, adding an aggregate of \$103.7 million of gross loans and \$117.7 million of deposits. A bargain purchase gain of \$7.5 million was recorded in connection with the acquisition, reflecting the fair value of net assets acquired in excess of the purchase price. On May 10, 2013, Sterling paid \$123.0 million to acquire the Puget Sound operations of Boston Private Bank & Trust

Company ("Boston Private"), which added \$278.5 million of performing loans and \$168.2 million of deposits.

During the third quarter of 2013, Sterling received regulatory approval for the acquisition of Newport Beach, Calif.-based Commerce National Bank ("CNB"). Subsequent to period end, on October 1, 2013, Sterling paid \$42.9 million in cash to acquire CNB. At closing, Commerce National Bank had assets of \$259.9 million, loans of \$161.0 million, and deposits of \$189.6 million.

On September 11, 2013, Sterling entered into a definitive agreement to merge (the "Merger") with and into Umpqua Holdings Corporation ("Umpqua"), with headquarters in Portland, Oregon. Immediately after the Merger, Sterling Savings Bank will merge (the "Bank Merger") with and into Umpqua Bank, an Oregon state chartered bank and wholly owned subsidiary of Umpqua. Upon completion of the merger, the combined company will operate under the Umpqua Bank name and brand. The

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transaction is expected to be completed in the first half of 2014, subject to shareholder and regulatory approval and other customary closing conditions. Under the terms of the agreement, Sterling shareholders will receive 1.671 shares of Umpqua common stock and \$2.18 cash for each share of Sterling common stock.

## Selected Financial Data

|                                               | Three Months Ended |        | Nine Months Ended  |                   |   |
|-----------------------------------------------|--------------------|--------|--------------------|-------------------|---|
|                                               | September 30,      |        | September 30,      |                   |   |
|                                               | 2013               | 2012   | 2013               | 2012              |   |
| Basic earnings per share                      | \$0.34             | \$0.49 | \$1.15             | \$5.87            |   |
| Diluted earnings per share                    | \$0.33             | \$0.49 | \$1.13             | \$5.81            |   |
| Return on average assets                      | 0.84               | % 1.28 | % 1.00             | % 5.18            | % |
| Return on average equity                      | 6.9                | % 9.8  | % 7.8              | % 45.5            | % |
| Net interest margin (tax equivalent)          | 3.59               | % 3.43 | % 3.66             | % 3.46            | % |
| Efficiency ratio (1)                          | 70.8               | % 69.7 | % 68.7             | % 71.5            | % |
| Net charge-offs to average loans (annualized) | 0.06               | % 0.37 | % 0.21             | % 0.66            | % |
|                                               |                    |        | September 30, 2013 | December 31, 2012 |   |
| Book value per share                          |                    |        | \$19.51            | \$19.58           |   |
| Tangible book value per share                 |                    |        | \$18.66            | \$18.91           |   |
| Market value per share                        |                    |        | \$28.65            | \$20.90           |   |
| Tier 1 leverage ratio (consolidated)          |                    |        | 11.9               | % 12.1            | % |
| Loan loss allowance to total loans            |                    |        | 1.94               | % 2.47            | % |
| Nonperforming assets to total assets          |                    |        | 1.36               | % 2.28            | % |

(1) The efficiency ratio is noninterest expense, excluding OREO and amortization of other intangible assets, divided by net interest income (tax equivalent) plus noninterest income, excluding gains on sales of securities, other-than-temporary impairment losses on securities, charge on prepayment of debt, gain on branch divestitures and bargain purchase gain.

## 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:

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|                                               | Three Months Ended<br>September 30, 2013 |                                |                  | September 30, 2012 |                                |                  |      |   |
|-----------------------------------------------|------------------------------------------|--------------------------------|------------------|--------------------|--------------------------------|------------------|------|---|
|                                               | Average<br>Balance                       | Interest<br>Income/<br>Expense | Yields/<br>Rates | Average<br>Balance | Interest<br>Income/<br>Expense | Yields/<br>Rates |      |   |
|                                               | (in thousands)                           |                                |                  |                    |                                |                  |      |   |
| <b>ASSETS:</b>                                |                                          |                                |                  |                    |                                |                  |      |   |
| Loans:                                        |                                          |                                |                  |                    |                                |                  |      |   |
| Mortgage                                      | \$4,495,451                              | \$49,689                       | 4.42             | %                  | \$3,863,670                    | \$47,757         | 4.94 | % |
| Commercial and consumer                       | 2,933,727                                | 36,558                         | 4.94             | %                  | 2,583,756                      | 35,479           | 5.46 | % |
| Total loans <sup>(1)</sup>                    | 7,429,178                                | 86,247                         | 4.63             | %                  | 6,447,426                      | 83,236           | 5.15 | % |
| MBS <sup>(2)</sup>                            | 1,313,728                                | 8,079                          | 2.46             | %                  | 1,762,950                      | 10,361           | 2.35 | % |
| Investments and cash <sup>(2)</sup>           | 404,134                                  | 3,132                          | 3.07             | %                  | 529,407                        | 3,392            | 2.55 | % |
| FHLB stock                                    | 95,923                                   | 0                              | 0.00             | %                  | 99,160                         | 0                | 0.00 | % |
| Total interest earning assets                 | 9,242,963                                | 97,458                         | 4.20             | %                  | 8,838,943                      | 96,989           | 4.38 | % |
| Noninterest earning assets <sup>(3)</sup>     | 643,496                                  |                                |                  |                    | 681,587                        |                  |      |   |
| Total average assets                          | \$9,886,459                              |                                |                  |                    | \$9,520,530                    |                  |      |   |
| <b>LIABILITIES and EQUITY:</b>                |                                          |                                |                  |                    |                                |                  |      |   |
| Deposits:                                     |                                          |                                |                  |                    |                                |                  |      |   |
| Interest bearing transaction                  | \$745,131                                | 66                             | 0.04             | %                  | \$684,906                      | 73               | 0.04 | % |
| Savings and MMDA                              | 2,489,950                                | 865                            | 0.14             | %                  | 2,284,749                      | 884              | 0.15 | % |
| Time deposits                                 | 1,769,741                                | 5,110                          | 1.15             | %                  | 2,168,056                      | 8,024            | 1.47 | % |
| Total interest bearing deposits               | 5,004,822                                | 6,041                          | 0.48             | %                  | 5,137,711                      | 8,981            | 0.70 | % |
| Borrowings                                    | 1,777,268                                | 7,855                          | 1.75             | %                  | 1,358,348                      | 11,702           | 3.43 | % |
| Total interest bearing liabilities            | 6,782,090                                | 13,896                         | 0.81             | %                  | 6,496,059                      | 20,683           | 1.27 | % |
| Noninterest bearing transaction               | 1,787,716                                | 0                              | 0.00             | %                  | 1,656,318                      | 0                | 0.00 | % |
| Total funding liabilities                     | 8,569,806                                | 13,896                         | 0.64             | %                  | 8,152,377                      | 20,683           | 1.01 | % |
| Other noninterest bearing liabilities         | 109,839                                  |                                |                  |                    | 130,948                        |                  |      |   |
| Total average liabilities                     | 8,679,645                                |                                |                  |                    | 8,283,325                      |                  |      |   |
| Total average equity                          | 1,206,814                                |                                |                  |                    | 1,237,205                      |                  |      |   |
| Total average liabilities and equity          | \$9,886,459                              |                                |                  |                    | \$9,520,530                    |                  |      |   |
| Net interest income and spread <sup>(4)</sup> |                                          | \$83,562                       | 3.39             | %                  |                                | \$76,306         | 3.11 | % |
| Net interest margin <sup>(4)</sup>            |                                          |                                | 3.59             | %                  |                                |                  | 3.43 | % |
| Deposits:                                     |                                          |                                |                  |                    |                                |                  |      |   |
| Total interest bearing deposits               | \$5,004,822                              | \$6,041                        | 0.48             | %                  | \$5,137,711                    | \$8,981          | 0.70 | % |
| Noninterest bearing transaction               | 1,787,716                                | 0                              | 0.00             | %                  | 1,656,318                      | 0                | 0.00 | % |
| Total deposits                                | \$6,792,538                              | \$6,041                        | 0.35             | %                  | \$6,794,029                    | \$8,981          | 0.53 | % |

(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.

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|                                               | Nine Months Ended<br>September 30, 2013 |                                |                  | September 30, 2012 |                                |                  |      |   |
|-----------------------------------------------|-----------------------------------------|--------------------------------|------------------|--------------------|--------------------------------|------------------|------|---|
|                                               | Average<br>Balance                      | Interest<br>Income/<br>Expense | Yields/<br>Rates | Average<br>Balance | Interest<br>Income/<br>Expense | Yields/<br>Rates |      |   |
| <b>ASSETS:</b>                                |                                         |                                |                  |                    |                                |                  |      |   |
| Loans:                                        |                                         |                                |                  |                    |                                |                  |      |   |
| Mortgage                                      | \$4,299,901                             | \$145,969                      | 4.53             | %                  | \$3,757,341                    | \$141,306        | 5.01 | % |
| Commercial and consumer                       | 2,822,125                               | 106,154                        | 5.03             | %                  | 2,555,147                      | 107,504          | 5.62 | % |
| Total loans <sup>(1)</sup>                    | 7,122,026                               | 252,123                        | 4.73             | %                  | 6,312,488                      | 248,810          | 5.26 | % |
| MBS <sup>(2)</sup>                            | 1,251,460                               | 22,709                         | 2.42             | %                  | 1,989,989                      | 38,632           | 2.59 | % |
| Investments and cash <sup>(2)</sup>           | 405,501                                 | 9,411                          | 3.09             | %                  | 553,827                        | 10,634           | 2.56 | % |
| FHLB stock                                    | 96,775                                  | 0                              | 0.00             | %                  | 99,148                         | 0                | 0.00 | % |
| Total interest earning assets                 | 8,875,762                               | 284,243                        | 4.27             | %                  | 8,955,452                      | 298,076          | 4.44 | % |
| Noninterest earning assets <sup>(3)</sup>     | 652,291                                 |                                |                  |                    | 442,691                        |                  |      |   |
| Total average assets                          | \$9,528,053                             |                                |                  |                    | \$9,398,143                    |                  |      |   |
| <b>LIABILITIES and EQUITY:</b>                |                                         |                                |                  |                    |                                |                  |      |   |
| Deposits:                                     |                                         |                                |                  |                    |                                |                  |      |   |
| Interest bearing transaction                  | \$740,469                               | 201                            | 0.04             | %                  | \$637,106                      | 271              | 0.06 | % |
| Savings and MMDA                              | 2,409,564                               | 2,430                          | 0.13             | %                  | 2,252,052                      | 3,101            | 0.18 | % |
| Time deposits                                 | 1,744,099                               | 15,755                         | 1.21             | %                  | 2,369,682                      | 26,632           | 1.50 | % |
| Total interest bearing deposits               | 4,894,132                               | 18,386                         | 0.50             | %                  | 5,258,840                      | 30,004           | 0.76 | % |
| Borrowings                                    | 1,561,668                               | 22,976                         | 1.97             | %                  | 1,489,663                      | 36,371           | 3.26 | % |
| Total interest bearing liabilities            | 6,455,800                               | 41,362                         | 0.86             | %                  | 6,748,503                      | 66,375           | 1.31 | % |
| Noninterest bearing transaction               | 1,733,277                               | 0                              | 0.00             | %                  | 1,498,471                      | 0                | 0.00 | % |
| Total funding liabilities                     | 8,189,077                               | 41,362                         | 0.68             | %                  | 8,246,974                      | 66,375           | 1.08 | % |
| Other noninterest bearing liabilities         | 114,681                                 |                                |                  |                    | 80,176                         |                  |      |   |
| Total average liabilities                     | 8,303,758                               |                                |                  |                    | 8,327,150                      |                  |      |   |
| Total average equity                          | 1,224,295                               |                                |                  |                    | 1,070,993                      |                  |      |   |
| Total average liabilities and equity          | \$9,528,053                             |                                |                  |                    | \$9,398,143                    |                  |      |   |
| Net interest income and spread <sup>(4)</sup> |                                         | \$242,881                      | 3.41             | %                  |                                | \$231,701        | 3.13 | % |
| Net interest margin <sup>(4)</sup>            |                                         |                                | 3.66             | %                  |                                |                  | 3.46 | % |
| Deposits:                                     |                                         |                                |                  |                    |                                |                  |      |   |
| Total interest bearing deposits               | \$4,894,132                             | \$18,386                       | 0.50             | %                  | \$5,258,840                    | \$30,004         | 0.76 | % |
| Noninterest bearing transaction               | 1,733,277                               | 0                              | 0.00             | %                  | 1,498,471                      | 0                | 0.00 | % |
| Total deposits                                | \$6,627,409                             | \$18,386                       | 0.37             | %                  | \$6,757,311                    | \$30,004         | 0.59 | % |

(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.

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Net Interest Income. Sterling's net interest income increased \$7.2 million and \$11.3 million for the three and nine months ended September 30, 2013 respectively, compared with the three and nine months ended September 30, 2012, as a result of the decline in funding costs and an increase in interest income on loans, partially offset by a decline in interest income on MBS. Funding costs declined as a result of the decline in time deposits, as well as a lower balance of higher cost wholesale borrowings from securities sold under repurchase agreements. Average loan balances increased 15% and 13% for the three and nine months ended September 30, 2013 respectively, compared with the three and nine months ended September 30, 2012, while average MBS balances declined 25% and 37% over the same comparable periods. The decline in average MBS balances reflected sales during 2012 to fund the reduction in repurchase agreements.

Provision for Credit Losses. During the three and nine months ended September 30, 2013, there was no provision for credit losses, compared with \$2.0 million and \$10.0 million for the comparative 2012 periods, respectively. The reduced level of credit loss provisioning reflects improvement in asset quality as evidenced by the decline in nonperforming loans.

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

|                                                      | Three Months Ended September 30, |          |          | Nine Months Ended September 30, |           |           |       |    |
|------------------------------------------------------|----------------------------------|----------|----------|---------------------------------|-----------|-----------|-------|----|
|                                                      | 2013                             | 2012     | % Change | 2013                            | 2012      | % Change  |       |    |
|                                                      | (in thousands)                   |          |          |                                 |           |           |       |    |
| Fees and service charges                             | \$15,380                         | \$14,675 | 5        | %                               | \$45,128  | \$41,546  | 9     | %  |
| Mortgage banking operations                          | 13,494                           | 26,410   | (49)     | )%                              | 50,468    | 69,135    | (27)  | )% |
| BOLI                                                 | 1,640                            | 1,660    | (1)      | )%                              | 4,621     | 7,175     | (36)  | )% |
| Gains on sales of securities, net                    | 0                                | 3,129    | (100)    | )%                              | 0         | 12,592    | (100) | )% |
| Other-than-temporary impairment losses on securities | 0                                | 0        | 0        | %                               | 0         | (6,819)   | (100) | )% |
| Charge on prepayment of debt                         | 0                                | 0        | 0        | %                               | 0         | (2,664)   | (100) | )% |
| Gains on other loan sales                            | 1,135                            | 476      | 138      | %                               | 2,354     | 3,887     | (39)  | )% |
| Other                                                | 241                              | 348      | (31)     | )%                              | 8,888     | (1,826)   | *     |    |
| Total noninterest income                             | \$31,890                         | \$46,698 | (32)     | )%                              | \$111,459 | \$123,026 | (9)   | )% |

\* Not meaningful

Fees and service charges increased over the periods presented due to an increase in deposit fee income and loan prepayment penalties. BOLI income during the nine months ended September 30, 2012 included \$2.4 million relating to a death benefit. For the 2013 periods, Sterling had no gains or losses on the sale of securities, compared with gains of \$3.1 million and \$12.6 million for the three and nine month respective 2012 periods. Also, during the nine months ended September 30, 2012, Sterling recognized an other-than-temporary impairment charge of \$6.8 million, and a prepayment of debt charge of \$2.7 million. There were no similar charges in the 2013 periods. Gains on other loan sales during the 2013 periods were due to SBA lending activity, while the 2012 gains on other loan sales were primarily related to the sale of nonperforming loans at a premium to carrying value.

Other noninterest income during the nine months ended September 30, 2013 included a \$7.5 million bargain purchase gain in connection with the Borrego acquisition. The sale of three branches during the nine months ended September 30, 2013 resulted in a gain of \$893,000, before associated expenses of \$254,000 that are included in other noninterest expenses. In the comparable 2012 period, branch consolidations resulted in a loss of \$1.7 million. Other noninterest income for the nine months ended September 30, 2012 also included a negative valuation adjustment of \$600,000 on interest rate swaps.



Mortgage banking income for the three and nine months ended September 30, 2013 declined 49% and 27%, respectively, over the comparative 2012 periods, reflecting lower margins and volumes. During 2013, mortgage rates have increased over 100 basis points, and subsequently, mortgage refinance originations have declined 50% from the second quarter 2013. Included in income from mortgage banking operations for the three and nine months ended September 30, 2013 was a \$491,000 and \$6.1 million valuation increase on mortgage servicing rights, respectively, compared with write-downs of \$2.1 million and \$984,000, respectively, during the three and nine months ended September 30, 2012. During the nine months ended September 30, 2013, income from mortgage banking also included a \$790,000 reduction in the fair value of a pool of portfolio residential mortgage loans that were previously classified as held for sale.

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

|                                             | Three Months Ended September 30, |           | Nine Months Ended September 30, |             |   |
|---------------------------------------------|----------------------------------|-----------|---------------------------------|-------------|---|
|                                             | 2013                             | 2012      | 2013                            | 2012        |   |
|                                             | (in thousands)                   |           |                                 |             |   |
| Residential loan sales                      | \$672,604                        | \$728,642 | \$2,251,923                     | \$1,869,213 |   |
| Change in warehouse and interest rate locks | (198,389 )                       | 36,018    | (330,681 )                      | 348,600     |   |
| Total mortgage banking activity             | \$474,215                        | \$764,660 | \$1,921,242                     | \$2,217,813 |   |
| Margin on residential loan sales            | 2.31                             | % 3.68    | % 2.10                          | % 3.07      | % |

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

|                                         | Three Months Ended September 30, |          |          | Nine Months Ended September 30, |           |          |
|-----------------------------------------|----------------------------------|----------|----------|---------------------------------|-----------|----------|
|                                         | 2013                             | 2012     | % change | 2013                            | 2012      | % change |
|                                         | (in thousands)                   |          |          |                                 |           |          |
| Employee compensation and benefits      | \$47,058                         | \$45,636 | 3 %      | \$135,297                       | \$139,502 | (3 )%    |
| Occupancy and equipment                 | 9,959                            | 11,034   | (10 )%   | 29,385                          | 32,253    | (9 )%    |
| Data processing                         | 7,252                            | 7,137    | 2 %      | 20,300                          | 20,600    | (1 )%    |
| Professional fees                       | 3,093                            | 4,929    | (37 )%   | 12,030                          | 12,718    | (5 )%    |
| Depreciation                            | 3,358                            | 2,918    | 15 %     | 9,350                           | 8,754     | 7 %      |
| Merger and acquisition                  | 3,896                            | 1,584    | 146 %    | 7,200                           | 9,981     | (28 )%   |
| OREO operations                         | 1,877                            | 4,008    | (53 )%   | 6,456                           | 9,337     | (31 )%   |
| Advertising                             | 1,830                            | 3,442    | (47 )%   | 6,025                           | 10,370    | (42 )%   |
| FDIC insurance                          | 1,129                            | 2,159    | (48 )%   | 4,693                           | 6,005     | (22 )%   |
| Amortization of other intangible assets | 1,676                            | 1,792    | (6 )%    | 5,046                           | 4,988     | 1 %      |
| Travel and entertainment                | 1,467                            | 1,420    | 3 %      | 4,151                           | 4,019     | 3 %      |
| Other                                   | 2,739                            | 3,349    | (18 )%   | 9,008                           | 7,137     | 26 %     |
| Total noninterest expense               | \$85,334                         | \$89,408 | (5 )%    | \$248,941                       | \$265,664 | (6 )%    |

Employee compensation and benefits during the three months ended September 30, 2013 included acquisition related activity and new employees added in Southern California, while the nine months ended September 30, 2012 included severance costs related to a reduction in force, and a higher level of commissions from increased loan production levels. Occupancy and equipment have declined from the 2012 comparable periods, as a result of branch consolidations and sales. OREO operations also declined from the comparable periods, as a result of a lower level of OREO properties. Advertising expense during 2012 included costs related to the rebranding of Sterling Savings Bank as Sterling Bank. Merger and acquisition expense for the three months ended September 30, 2013 primarily related to the pending Umpqua Merger. Merger and acquisition expense for the nine months ended September 30, 2012 was comprised primarily of expenses related to the First Independent transaction. For the nine months ended September 30, 2012, other noninterest expense included a \$1.9 million Washington State Business and Occupation tax refund.

Income Tax Provision. During the three months ended September 30, 2013, Sterling recognized income tax expense of \$8.1 million, reflecting a 28% effective tax rate, and during the nine months ended September 30, 2013, income tax expense of \$30.9 million, reflecting a 30% effective tax rate. The nine month comparable 2012 period included an income tax benefit of \$288.8 million, the result of reversing substantially all of Sterling's deferred tax asset valuation allowance. The effective tax rate for the 2013 periods reflect permanent differences between book income and tax income from the Borrego acquisition bargain purchase gain, as well as tax exempt municipal bond and BOLI income. As of September 30, 2013, the net deferred tax asset was \$282.6 million, including \$245.3 million of net operating loss and tax credit carry-forwards, compared with \$292.1 million as of December 31, 2012, including \$274.0 million of net operating loss and tax credit carry-forwards.



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## Financial Position

Assets. At September 30, 2013, Sterling's assets were \$9.98 billion, an increase of \$747.4 million from December 31, 2012. The Borrego acquisition in the first quarter of 2013 added total assets of \$141.6 million, while the Boston Private transaction in the second quarter of 2013 added total assets of \$292.1 million. The other primary contributor to the increase in assets was organic loan growth.

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

|                                 | September 30, 2013 |     | December 31, 2012 |     |   |
|---------------------------------|--------------------|-----|-------------------|-----|---|
|                                 | Amount             | %   | Amount            | %   |   |
|                                 | (in thousands)     |     |                   |     |   |
| Residential real estate         | \$1,052,381        | 15  | \$806,722         | 13  |   |
| Commercial real estate ("CRE"): |                    |     |                   |     |   |
| Investor CRE                    | 1,125,477          | 16  | 1,219,847         | 20  |   |
| Multifamily                     | 2,029,820          | 28  | 1,580,289         | 25  |   |
| Construction                    | 52,929             | 1   | 74,665            | 1   |   |
| Total CRE                       | 3,208,226          | 45  | 2,874,801         | 46  |   |
| Commercial:                     |                    |     |                   |     |   |
| Owner occupied CRE              | 1,404,006          | 20  | 1,276,591         | 20  |   |
| Commercial & Industrial ("C&I") | 681,666            | 10  | 540,499           | 9   |   |
| Total commercial                | 2,085,672          | 30  | 1,817,090         | 29  |   |
| Consumer                        | 807,964            | 10  | 754,621           | 12  |   |
| Gross loans receivable          | 7,154,243          | 100 | % 6,253,234       | 100 | % |
| Deferred loan fees, net         | 8,781              |     | 2,860             |     |   |
| Allowance for loan losses       | (138,698)          | )   | (154,345)         | )   |   |
| Loans receivable, net           | \$7,024,326        |     | \$6,101,749       |     |   |

The acquisition of Borrego during the first quarter 2013 added \$97.3 million of loans, which were primarily SBA loans that have been included in the table above in owner occupied CRE. The Boston Private transaction during the second quarter of 2013 added \$273.4 million of loans, approximately 37% of which were commercial, 36% were CRE, and 26% were residential real estate. Excluding loans acquired in these transactions, gross portfolio loan balances expanded at an annualized rate of 11% during the nine months ended September 30, 2013.

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The following table sets forth Sterling's loan originations and purchases for the periods indicated. These amounts do not include the amounts acquired in the Borrego and Boston Private transactions during 2013, or amounts acquired in the 2012 First Independent transaction:

|                                                                               | Three Months Ended    |                       | Nine Months Ended     |                       |
|-------------------------------------------------------------------------------|-----------------------|-----------------------|-----------------------|-----------------------|
|                                                                               | September 30,<br>2013 | September 30,<br>2012 | September 30,<br>2013 | September 30,<br>2012 |
|                                                                               | (in thousands)        |                       |                       |                       |
| Loan originations:                                                            |                       |                       |                       |                       |
| Residential real estate:                                                      |                       |                       |                       |                       |
| For sale                                                                      | \$535,039             | \$842,197             | \$1,967,626           | \$1,997,491           |
| Permanent                                                                     | 142,837               | 77,650                | 358,174               | 152,947               |
| Total residential real estate                                                 | 677,876               | 919,847               | 2,325,800             | 2,150,438             |
| CRE:                                                                          |                       |                       |                       |                       |
| Investor CRE                                                                  | 8,539                 | 14,889                | 45,875                | 37,535                |
| Multifamily                                                                   | 169,868               | 144,560               | 636,217               | 552,241               |
| Construction                                                                  | 8,767                 | 776                   | 17,428                | 2,444                 |
| Total CRE                                                                     | 187,174               | 160,225               | 699,520               | 592,220               |
| Commercial:                                                                   |                       |                       |                       |                       |
| Owner occupied CRE                                                            | 59,403                | 53,541                | 159,260               | 111,833               |
| C&I                                                                           | 85,495                | 102,255               | 272,556               | 206,310               |
| Total commercial                                                              | 144,898               | 155,796               | 431,816               | 318,143               |
| Consumer                                                                      | 112,887               | 63,435                | 297,339               | 199,881               |
| Total loan originations                                                       | 1,122,835             | 1,299,303             | 3,754,475             | 3,260,682             |
| Total portfolio loan originations (excludes residential real estate for sale) | 587,796               | 457,106               | 1,786,849             | 1,263,191             |
| Loan purchases:                                                               |                       |                       |                       |                       |
| Residential real estate                                                       | 51                    | 1,646                 | 228                   | 76,408                |
| CRE:                                                                          |                       |                       |                       |                       |
| Investor CRE                                                                  | 1,100                 | 0                     | 3,016                 | 0                     |
| Multifamily                                                                   | 199                   | 292                   | 484                   | 683                   |
| Total CRE                                                                     | 1,299                 | 292                   | 3,500                 | 683                   |
| Commercial:                                                                   |                       |                       |                       |                       |
| Owner occupied CRE                                                            | 0                     | 0                     | 1,071                 | 0                     |
| C&I                                                                           | 24,164                | 0                     | 45,164                | 0                     |
| Total commercial                                                              | 24,164                | 0                     | 46,235                | 0                     |
| Consumer                                                                      | 5,758                 | 41,567                | 26,209                | 52,307                |
| Total loan purchases                                                          | 31,272                | 43,505                | 76,172                | 129,398               |
| Total loan originations and purchases                                         | \$1,154,107           | \$1,342,808           | \$3,830,647           | \$3,390,080           |

Portfolio loan originations grew by 29% and 41% during the three and nine months ended September 30, 2013, respectively, over the 2012 comparative periods. Multifamily portfolio loan originations during the three and nine months ended September 30, 2013 were 29% and 36%, respectively, of total portfolio originations, with residential permanent, consumer and C&I being the other primary contributors. Originations of residential for sale loans during the first half of 2013 were positively influenced by an elevated level of refinancing activity due to historically low mortgage rates. Following a 100+ basis point rise in mortgage rates, mortgage refinance originations during the third quarter declined 50% from the second quarter of 2013. Loan purchases during 2013 included \$45.2 million of C&I syndicated loans, and participations of \$20.5 million of auto loans and \$5.2 million of student loans.



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

|                                                     | Three Months Ended<br>September 30,<br>2013 |            | Nine Months Ended<br>September 30,<br>2013 |            |
|-----------------------------------------------------|---------------------------------------------|------------|--------------------------------------------|------------|
|                                                     | 2012                                        |            | 2012                                       |            |
|                                                     | (in thousands)                              |            |                                            |            |
| Allowance for credit losses                         |                                             |            |                                            |            |
| Allowance - loans, beginning balance                | \$ 141,949                                  | \$ 158,244 | \$ 154,345                                 | \$ 177,458 |
| Provision                                           | (2,100 )                                    | 2,000      | (4,700 )                                   | 8,000      |
| Charge-offs                                         | (4,488 )                                    | (10,479 )  | (19,420 )                                  | (51,056 )  |
| Recoveries                                          | 3,337                                       | 4,514      | 8,473                                      | 19,877     |
| Allowance - loans, ending balance                   | 138,698                                     | 154,279    | 138,698                                    | 154,279    |
| Allowance - unfunded commitments, beginning balance | 9,505                                       | 7,952      | 8,002                                      | 10,029     |
| Provision                                           | 2,100                                       | 0          | 4,700                                      | 2,000      |
| Charge-offs                                         | (1,064 )                                    | (181 )     | (2,161 )                                   | (4,258 )   |
| Allowance - unfunded commitments, ending balance    | 10,541                                      | 7,771      | 10,541                                     | 7,771      |
| Total credit allowance                              | \$ 149,239                                  | \$ 162,050 | \$ 149,239                                 | \$ 162,050 |

See Note 4 of the Notes to Consolidated Financial Statements for additional details by loan segment for changes in the allowance for credit losses. The decline in the allowance for credit losses over the periods presented was due to net charge-offs exceeding the level of provisioning, reflecting a reduction in the level of classified loans, as well as lower historical loss rates. The following table presents classified assets, which are comprised of loans risk rated as substandard, doubtful or loss, and OREO.

|                                   | September 30, 2013 | December 31, 2012 |   |
|-----------------------------------|--------------------|-------------------|---|
|                                   | (in thousands)     |                   |   |
| Residential real estate           | \$22,076           | \$26,915          |   |
| CRE:                              |                    |                   |   |
| Investor CRE                      | 25,720             | 70,044            |   |
| Multifamily                       | 1,343              | 8,964             |   |
| Construction                      | 4,260              | 17,800            |   |
| Total CRE                         | 31,323             | 96,808            |   |
| Commercial:                       |                    |                   |   |
| Owner occupied CRE                | 41,562             | 58,119            |   |
| C&I                               | 22,075             | 6,006             |   |
| Total commercial                  | 63,637             | 64,125            |   |
| Consumer                          | 6,058              | 8,942             |   |
| Total classified loans            | 123,094            | 196,790           |   |
| OREO                              | 17,464             | 25,042            |   |
| Total classified assets           | \$140,558          | \$221,832         |   |
| Classified loans to loans         | 1.72               | % 3.15            | % |
| Classified assets to total assets | 1.41               | % 2.40            | % |

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Classified assets declined \$81.3 million, or 37% during the nine months ended September 30, 2013, despite the addition of \$17.2 million of classified assets during this period as a result of the Borrego transaction. Nonperforming assets include nonperforming loans and OREO, are summarized in the following table as of the dates indicated:

|                                            | September 30,<br>2013 | December 31,<br>2012 |  |   |
|--------------------------------------------|-----------------------|----------------------|--|---|
|                                            | (in thousands)        |                      |  |   |
| Past due 90 days or more and accruing      | \$0                   | \$0                  |  |   |
| Nonaccrual loans                           | 65,410                | 121,113              |  |   |
| Restructured loans                         | 52,556                | 64,216               |  |   |
| Total nonperforming loans                  | 117,966               | 185,329              |  |   |
| OREO                                       | 17,464                | 25,042               |  |   |
| Total nonperforming assets                 | 135,430               | 210,371              |  |   |
| Specific reserve - loans                   | (4,900 )              | (8,463 )             |  |   |
| Net nonperforming assets                   | \$130,530             | \$201,908            |  |   |
| Guaranteed portion of nonperforming loans  | \$13,818              | \$10,702             |  |   |
| Nonperforming loans to loans               | 1.65                  | % 2.96               |  | % |
| Nonperforming assets to total assets       | 1.36                  | % 2.28               |  | % |
| Loan loss allowance to nonperforming loans | 118                   | % 83                 |  | % |

Nonperforming assets decreased 36% during the nine months ended September 30, 2013, despite the Borrego transaction adding \$18.3 million of nonperforming assets, a substantial portion of which are guaranteed by government agencies. The following table presents a roll-forward of nonperforming loans for the periods indicated:

|                      | Three Months Ended September 30, |           | Nine Months Ended September 30, |            |
|----------------------|----------------------------------|-----------|---------------------------------|------------|
|                      | 2013                             | 2012      | 2013                            | 2012       |
| Nonperforming loans: | (in thousands)                   |           |                                 |            |
| Beginning Balance    | \$142,731                        | \$265,340 | \$185,329                       | \$287,160  |
| Additions            | 12,785                           | 29,957    | 43,905                          | 129,488    |
| Charge-offs          | (1,151 )                         | (5,965 )  | (10,947 )                       | (31,179 )  |
| Paydowns and sales   | (32,079 )                        | (58,967 ) | (81,399 )                       | (106,981 ) |
| Acquired             | 0                                | 0         | 14,251                          | 0          |
| Foreclosures         | (2,453 )                         | (7,979 )  | (17,627 )                       | (30,503 )  |
| Upgrade to accrual   | (1,867 )                         | (9,948 )  | (15,546 )                       | (35,547 )  |
| Ending Balance       | \$117,966                        | \$212,438 | \$117,966                       | \$212,438  |

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

|                       | Three Months Ended September 30, |            |           |            | Nine Months Ended September 30, |            |           |            |
|-----------------------|----------------------------------|------------|-----------|------------|---------------------------------|------------|-----------|------------|
|                       | 2013                             |            | 2012      |            | 2013                            |            | 2012      |            |
|                       | Amount                           | Properties | Amount    | Properties | Amount                          | Properties | Amount    | Properties |
| OREO:                 | (dollars in thousands)           |            |           |            |                                 |            |           |            |
| Beginning Balance     | \$26,511                         | 42         | \$55,801  | 81         | \$25,042                        | 46         | \$81,910  | 143        |
| Additions             | 2,453                            | 14         | 8,131     | 28         | 17,329                          | 62         | 30,661    | 97         |
| Valuation adjustments | (1,687 )                         |            | (1,656 )  |            | (4,682 )                        |            | (5,028 )  |            |
| Sales                 | (9,358 )                         | (23 )      | (15,666 ) | (39 )      | (24,921 )                       | (88 )      | (62,202 ) | (170 )     |
| Acquired              | 0                                | 0          | 0         | 0          | 4,375                           | 13         | 0         | 0          |
| Other changes         | (455 )                           |            | (35 )     |            | 321                             |            | 1,234     |            |
| Ending Balance        | \$17,464                         | 33         | \$46,575  | 70         | \$17,464                        | 33         | \$46,575  | 70         |



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OREO declined 63% compared with September 30, 2012, reflecting Sterling's continuing asset resolution efforts. The following table presents the property type composition of OREO as of the following dates:

|                         | September 30, 2013     |                      | December 31, 2012 |                      |
|-------------------------|------------------------|----------------------|-------------------|----------------------|
|                         | Amount                 | Number of Properties | Amount            | Number of Properties |
| OREO:                   | (dollars in thousands) |                      |                   |                      |
| Residential real estate | \$889                  | 7                    | \$2,448           | 12                   |
| CRE:                    |                        |                      |                   |                      |
| Investor CRE            | 2,475                  | 3                    | 1,636             | 4                    |
| Multifamily             | 0                      | 0                    | 0                 | 0                    |
| Construction            | 11,926                 | 4                    | 17,304            | 9                    |
| Commercial:             |                        |                      |                   |                      |
| Owner occupied CRE      | 2,113                  | 16                   | 3,194             | 13                   |
| C&I                     | 0                      | 0                    | 0                 | 0                    |
| Consumer                | 61                     | 3                    | 460               | 8                    |
| Ending Balance          | \$17,464               | 33                   | \$25,042          | 46                   |

As of September 30, 2013 and December 31, 2012, construction OREO was primarily comprised of one completed assisted living facility.

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

|                                 | September 30, 2013 |     | December 31, 2012 |     |   |
|---------------------------------|--------------------|-----|-------------------|-----|---|
|                                 | Amount             | %   | Amount            | %   |   |
|                                 | (in thousands)     |     |                   |     |   |
| Noninterest bearing transaction | \$1,818,194        | 27  | % \$1,702,740     | 26  | % |
| Interest bearing transaction    | 750,699            | 11  | % 732,038         | 11  | % |
| Savings and MMDA                | 2,542,631          | 37  | % 2,262,369       | 36  | % |
| Time deposits                   | 1,742,918          | 25  | % 1,738,970       | 27  | % |
| Total deposits                  | \$6,854,442        | 100 | % \$6,436,117     | 100 | % |

The increase in total deposits from December 31, 2012 included \$118.2 million of deposits from the Borrego acquisition, and \$168.2 million of deposits from the Boston Private transaction.

Borrowings. In addition to deposits, Sterling uses other borrowings as sources of funds. The aggregate amount of other borrowings outstanding comprised of FHLB advances, repurchase agreements and junior subordinated debentures, was \$1.81 billion as of September 30, 2013 compared with \$1.44 billion at December 31, 2012, respectively. The increase was in FHLB advances, which were used to fund acquisitions and loan growth, and to offset deposit outflow associated with branch divestitures and runoff of high-rate CDs.

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## 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.

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:

|                                                         | September 30,<br>2013                 | December 31,<br>2012                  |
|---------------------------------------------------------|---------------------------------------|---------------------------------------|
| Change in Interest Rate in<br>Basis Points (Rate Shock) | % Change in<br>Net Interest<br>Income | % Change in<br>Net Interest<br>Income |
| +300                                                    | (0.5                                  | ) 2.0                                 |
| +200                                                    | 0.1                                   | 1.8                                   |
| +100                                                    | 0.1                                   | 1.0                                   |
| 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:

| September 30,<br>2013 | December 31,<br>2012 |
|-----------------------|----------------------|
|-----------------------|----------------------|

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| Change in Interest Rate in<br>Basis Points (Rate Shock) | % Change in<br>EVE | % Change in<br>EVE |
|---------------------------------------------------------|--------------------|--------------------|
| +300                                                    | 7.1                | 29.9               |
| +200                                                    | 4.9                | 23.8               |
| +100                                                    | 2.3                | 13.7               |
| Static                                                  | 0.0                | 0.0                |
| -100                                                    | *                  | *                  |

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

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The fluctuations in EVE sensitivity and net interest income interest rate shock from December 31, 2012 as compared with September 30, 2013 are primarily the result of an increase in short-term borrowings to fund fixed-rate, longer-duration assets that were added through organic growth and acquisitions over the past nine months.

Sterling has customer-related interest rate swap derivatives outstanding, with a total notional amount of \$51.3 million of related swaps outstanding as of September 30, 2013. For a description, see Note 11 of Notes to Consolidated Financial Statements. As of September 30, 2013, 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.

## 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. 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. 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 long-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 \$1.85 billion at September 30, 2013, compared with \$1.84 billion at December 31, 2012. Total available liquidity as of September 30, 2013 was \$2.91 billion, compared to \$2.93 billion as of December 31, 2012. Total available liquidity as of September 30, 2013 included unpledged portions of cash and equivalents and securities of \$575.4 million, available borrowing capacity from the FHLB, the Federal Reserve and correspondent banks of \$2.09 billion, as well as loans held for sale of \$245.8 million.

Sterling, as a parent company-only, had cash of approximately \$26.6 million and \$24.4 million at September 30, 2013 and December 31, 2012, 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. 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 inherent 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 primarily 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.

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The loan portfolio is grouped into several 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 qualitative factors are reviewed quarterly to determine a rating for each category of low, medium, and high, that is then quantified into the calculation of the probability of default. The estimated loss emergence period reflects an estimate of the time frame during which losses may be realized. Sterling establishes the estimated loss rate on loans using the historical life-to-date losses net of recoveries on loans remaining in the portfolio, the last twelve months of losses on OREO (including losses on foreclosure, write-downs, and losses on sale) and losses on discounted note sales 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 estimated loss rates for each loan class. Once the estimated loss rates for each loan class are calculated, the results are validated, by comparing this calculated estimated loss for each loan class to the actual one-year and three-year (annualized) losses, net of recoveries. In addition, the calculated inherent loss rate is also compared to the prior periods, and the overall trend in loss rates from prior periods. If the calculated loss rates differ significantly from the one-year and three-year actual loss rates and/or is inconsistent with the historical trends, Sterling performs further analyses to identify and evaluate the possible causes of the differences. This includes evaluating the characteristics of the historical loss and recovery data used in calculating the loss rate to determine whether such activity is an appropriate reflection, in management's judgment, of the current inherent losses in the various loan classes. This analysis takes into consideration the impact of the qualitative factors that increase the probability of default in the calculated loss rates in assessing whether there is additional qualitative risk. Sterling evaluates the results of the model, and the evaluation process and based on their judgment, experience, and specific knowledge of the loan portfolio, determines the most appropriate loss rate for each category based on their evaluation of quantitative data and qualitative factors described above.

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 estimated loss rates. 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 estimated 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

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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 a government 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. 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.

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, 2013.

**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 substantially all 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, 2013, 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, 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.

On July 2, 2013, the Federal Reserve issued capital regulations generally consistent with Basel III. The regulation includes: a permanent grandfathering of the existing tier 1 capital status of trust preferred junior subordinated debentures for banks with less than \$15 billion in total assets (subject to exceptions in the case of mergers); an option to exclude unrealized gains and losses on available for sale securities from tier 1 capital for banks with less than \$250 billion in total assets (subject to certain limitations for acquisition related asset growth); and mortgage risk weightings consistent with Basel I. If the rule were in effect at September 30, 2013, it would not materially impact Sterling's and Sterling Bank's regulatory capital ratios.

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On July 31, 2013, the U.S. District Court for the District of Columbia issued an order granting summary judgment to the plaintiffs in a case challenging certain provisions of the Federal Reserve's rule concerning debit card transaction fees that were adopted to implement Section 1075 of the Dodd-Frank Act, known as the Durbin Amendment. If this decision is ultimately upheld, the amount of debt card interchange fees that a bank subject to the Durbin Amendment would be permitted to charge likely would be reduced further than the 21 cent cap per transaction.

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Important Information For Investors And Shareholders

This communication does not constitute an offer to sell or the solicitation of an offer to buy any securities or a solicitation of any vote or approval, nor shall there be any sale of securities in any jurisdiction in which such offer, solicitation or sale would be unlawful prior to registration or qualification under the securities laws of such jurisdiction. Umpqua will file with the Securities and Exchange Commission ("SEC") a registration statement on Form S-4 containing a joint proxy statement/prospectus of Sterling and Umpqua, and Sterling and Umpqua will each file other documents with respect to the proposed merger. A definitive joint proxy statement/prospectus will be mailed to shareholders of Sterling and Umpqua. Investors and security holders of Sterling and Umpqua are urged to read the joint proxy statement/prospectus and other documents that will be filed with the SEC carefully and in their entirety when they become available because they will contain important information. Investors and security holders will be able to obtain free copies of the registration statement and the joint proxy statement/prospectus (when available) and other documents filed with the SEC by Sterling or Umpqua through the website maintained by the SEC at [www.sec.gov](http://www.sec.gov). Copies of the documents filed with the SEC by Sterling will be available free of charge on Sterling's website at [www.sterlingfinancialcorporation.com](http://www.sterlingfinancialcorporation.com) or by contacting Sterling's Investor Relations Department at 509-358-8097. Copies of the documents filed with the SEC by Umpqua will be available free of charge on Umpqua's website at [www.umpquaholdingscorp.com](http://www.umpquaholdingscorp.com) or by contacting Umpqua's Investor Relations Department at 503-268-6675.

Sterling, Umpqua, their respective directors and executive officers and other members of management and employees may be considered participants in the solicitation of proxies in connection with the proposed transaction. Information about the directors and executive officers of Sterling is set forth in its Annual Report on Form 10-K for the year ended December 31, 2012, which was filed with the SEC on February 27, 2013, its proxy statement for its 2013 annual meeting of stockholders, which was filed with the SEC on March 15, 2013, and its Current Reports on Form 8-K or 8-K/A, which were filed with the SEC on January 28, 2013 (Item 1.01), March 4, 2013, May 2, 2013 (Item 5.07), May 10, 2013, June 20, 2013 and August 9, 2013, respectively. Information about the directors and executive officers of Umpqua is set forth in its Annual Report on Form 10-K for the year ended December 31, 2012, which was filed with the SEC on February 15, 2013, its Quarterly Reports on Form 10-Q for the quarterly periods ended March 31, 2013 and June 30, 2013, which were filed with the SEC on May 2, 2013 and August 6, 2013, respectively, its proxy statement for its 2013 annual meeting of stockholders, which was filed with the SEC on February 25, 2013, and its Current Reports on Form 8-K, which were filed with the SEC on January 14, 2013, April 11, 2013 and April 22, 2013 (Item 5.07), respectively. Other information regarding the participants in the proxy solicitations and a description of their direct and indirect interests, by security holdings or otherwise, will be contained in the joint proxy statement/prospectus and other relevant materials to be filed with the SEC when they become available.

Cautionary Statement Regarding Forward-Looking Statements

This report contains certain "forward-looking statements" within the meaning of the safe harbor provisions of the United States Private Securities Litigation Reform Act of 1995. Forward-looking statements may be identified by the use of words such as "anticipate," "may," "can," "believe," "expect," "project," "intend," "likely," "plan," "seek," "should," "would," "estimate" and similar expressions and any other statements that predict or indicate future events or trends or that are not statements of historical facts. 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. All forward-looking statements are subject to numerous risks and uncertainties. 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 and Umpqua's control. These risks and uncertainties include, but are not limited to, the following: changes in general economic conditions 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 Sterling's loan and other products; changes in the monetary and fiscal policies of the federal government; changes in laws, regulations or the competitive environment; exposure to material litigation; failure to obtain the approval of shareholders of Sterling or Umpqua in connection with the merger; the timing to consummate the proposed merger; the risk that a condition to closing of the proposed merger may not be satisfied; the risk that a regulatory approval that may be required for the proposed merger is not obtained or is obtained subject to conditions that are not anticipated; the parties' ability to achieve the synergies and value creation contemplated by the proposed merger, or lower-than-expected revenue or cost savings or other issues in connection with mergers and acquisitions generally; the parties' ability to promptly and effectively integrate the businesses of Sterling and Umpqua; and the diversion of management time on issues related to the merger; the failure to consummate or delay in consummating the merger for other reasons. Sterling and Umpqua undertake no obligation (and expressly disclaim any such

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obligation) to publicly update or revise any forward-looking statement, whether as a result of new information, future events or otherwise. For additional information concerning factors that could cause actual conditions, events or results to materially differ from those described in the forward-looking statements, please refer to the factors set forth under the headings "Risk Factors" and "Management's Discussion and Analysis of Financial Condition and Results of Operations" in Sterling's and Umpqua's most recent Form 10-K and 10-Q reports and to Sterling's and Umpqua's most recent Form 8-K reports, which are available online at [www.sec.gov](http://www.sec.gov). No assurances can be given that any of the events anticipated by the forward-looking statements will transpire or occur, or if any of them do so, what impact they will have on the results of operations or financial condition of Sterling or Umpqua.

Other factors that could cause actual conditions, events or results to differ significantly from those described in the forward-looking statements may be found under the headings "Risk Factors" and "Management's Discussion and Analysis of Financial Condition and Results of Operations," in Sterling's Annual Report on Form 10-K for the fiscal year ended December 31, 2012, as updated periodically in Sterling's filings with the SEC. Unless legally required, Sterling disclaims any obligation to update any forward-looking statements.

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.

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PART II – Other Information

Item 1 Legal Proceedings

**Merger Litigation.** On September 18, 2013, Plaintiff Matthew Barnett filed a purported class action on behalf of Sterling's shareholders in connection with the proposed merger of Sterling and Umpqua in the Superior Court for Spokane County, Washington, docketed as Barnett v. Sterling Financial Corporation et al., No. 13-2-03848-4. On September 23, 2013, Plaintiff Vladimir Gusinsky Revocable Trust filed another purported class action in the Superior Court for Spokane County, docketed as Vladimir Gusinsky Revocable Trust v. Seibly et al., No. 13-2-03904-9. On September 26, 2013, Plaintiff Shoshana Minzer filed a third purported class action in the Superior Court for Spokane County, docketed as Minzer v. Sterling Financial Corporation et al., No. 13-2-03986-3. Each complaint names as defendants the members of Sterling's Board of Directors. The Barnett and Minzer complaints also name Sterling as a defendant. The Barnett and Gusinsky complaints also name Umpqua as a defendant.

The lawsuits allege, among other things, that the Board of Directors breached its fiduciary duties to stockholders by failing to take steps to maximize shareholder value or to engage in a fair sale process before approving the Merger. The lawsuits allege that the consideration to be paid by Umpqua is inadequate in light of Sterling's recent performance and growth potential, that Board members labored under conflicts of interest, that Sterling failed to negotiate a protective collar on the exchange ratio, and that the use of certain deal protection mechanisms precluded Sterling from investigating or pursuing alternatives or proposals superior to the Merger. Two of the lawsuits allege that Umpqua aided and abetted the Board's breaches of fiduciary duty.

On October 11, 2013, the Superior Court for Spokane County consolidated the three actions as In re Sterling Financial Corporation Merger Litigation, Lead No. 13-2-03848-4, and lead counsel was appointed.

The plaintiffs in these actions seek relief that includes, among other things, an injunction prohibiting the consummation of the Merger, rescission to the extent the Merger terms have already been implemented, damages for the breaches of fiduciary duty, and the payment of plaintiffs' attorneys' fees and costs. Sterling believes the lawsuits are without merit and intend to defend against them vigorously. There can be no assurance, however, with regard to the outcome of these lawsuits.

Currently, a loss resulting from these claims is not considered probable or reasonably estimable in amount.

**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 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. 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. On August 5, 2013, the court entered an order granting defendants' motion and dismissing the complaint in its entirety. On October 11, 2013, the lead plaintiff filed an amended consolidated complaint. The amended consolidated complaint names the same defendants, specifies the same class period, alleges the same violations of Sections 10(b) and 20(a) of the Securities & Exchange Act of 1934, and seeks the same relief. The amended consolidated complaint contains similar allegations of improper disclosure regarding Sterling's lending practices, status of loans and reserving and accounting for loans. Sterling believes the lawsuit is without merit and intends to defend against it vigorously. 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.

Additionally, Sterling is involved in ongoing litigation, primarily related to its normal business operations. When establishing a liability for contingent litigation losses, Sterling determines a range of potential losses for each matter that is both probable and estimable, and records the amount it considers to be the best estimate within the range. For these matters and others where an unfavorable outcome is reasonably possible but not probable, there is no estimable range of possible losses. Sterling believes that the eventual outcome from these cases will not, individually or in the aggregate, have a material adverse effect on its consolidated financial position.

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### Item 1A Risk Factors

Certain risks related to the proposed Merger with Umpqua are described below. These risk factors supplement and should be read together with those described in our Annual Report on Form 10-K for the fiscal year ended December 31, 2012. You should carefully consider all such risks and uncertainties 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.

The Merger is subject to certain closing conditions, including approval of the respective shareholders of each of Sterling and Umpqua, which may not be received, and required regulatory approvals, which may not be received, may take longer than expected or may impose conditions that are not presently anticipated or that could have an adverse effect on the combined company following the Merger. Before the Merger and the Bank Merger may be completed, Sterling and Umpqua must obtain approvals from their respective shareholders and from the Federal Reserve Board, the FDIC, and the Oregon Director and file a notification to the Washington DFI. Other approvals, waivers or consents from regulators may also be required. No assurance can be given as to whether or when these approvals will be received if the shareholders of either of Sterling or Umpqua do not approve the Merger, the Merger will not be completed. In determining whether to grant these regulatory approvals the regulators consider a variety of factors. An adverse development in either company's regulatory standing or other factors could result in an inability to obtain approval or delay receipt of approval. These regulators may impose conditions on the completion of the Merger or the Bank Merger or require changes to the terms of the Merger or the Bank Merger. Such conditions or changes could have the effect of delaying or preventing completion of the Merger or the Bank Merger or imposing additional costs on or limiting the revenues of the combined company following the Merger and the Bank Merger, any of which might have an adverse effect on the combined company following the Merger.

Combining the two companies may be more difficult, costly or time consuming than expected and the anticipated benefits and cost savings of the Merger may not be realized. Sterling and Umpqua have operated and, until the completion of the Merger, will continue to operate, independently. The success of the Merger, including anticipated benefits and cost savings, will depend, in part, on Umpqua's ability to successfully combine and integrate the businesses of Sterling and Umpqua in a manner that permits growth opportunities and does not materially disrupt the existing customer relations nor result in decreased revenues due to loss of customers. It is possible that the integration process could result in the loss of key employees, the disruption of either company's ongoing businesses or inconsistencies in standards, controls, procedures and policies that adversely affect the combined company's ability to maintain relationships with clients, customers, depositors and employees or to achieve the anticipated benefits and cost savings of the Merger. If difficulties with the integration process are encountered, the anticipated benefits of the Merger may not be realized fully or at all, or may take longer to realize than expected. As with any merger of financial institutions, there also may be business disruptions that cause Sterling to lose customers or cause customers to remove their accounts from Sterling and move their business to competing financial institutions. Integration efforts between the two companies will also divert management attention and resources. These integration matters could have an adverse effect on Sterling during this transition period and for an undetermined period after completion of the Merger. Termination of the merger agreement could negatively impact Sterling. If the merger agreement is terminated, there may be various consequences. For example, Sterling's businesses may have been impacted adversely by the failure to pursue other beneficial opportunities due to the focus of management on the Merger, without realizing any of the anticipated benefits of completing the Merger. Additionally, if the merger agreement is terminated, the market price of Sterling's common stock could decline to the extent that the current market price reflects a market assumption that the Merger will be completed. If the merger agreement is terminated under certain circumstances, Sterling may be required to pay to Umpqua a termination fee of \$75 million.



Sterling will be subject to business uncertainties and contractual restrictions while the Merger is pending. Uncertainty about the effect of the Merger on employees and customers may have an adverse effect on Sterling. These uncertainties may impair Sterling's ability to attract, retain and motivate key personnel until the Merger and associated integration process is completed, and could cause customers and others that deal with Sterling to seek to change or terminate existing business relationships with Sterling. Retention of certain employees by Sterling may be challenging while the Merger is pending, as certain employees may experience uncertainty about their future roles with Sterling. If key employees depart because of issues relating to the uncertainty and difficulty of integration or a desire not to remain with Sterling, Sterling's business could be harmed. In addition, subject to certain exceptions, Sterling has agreed to operate its business in the ordinary course and to comply with certain other operational restrictions, prior to closing.

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If the Merger is not completed, Sterling will have incurred substantial expenses without realizing the expected benefits of the Merger. Sterling has incurred and will incur substantial expenses in connection with the negotiation and completion of the transactions contemplated by the merger agreement. If the Merger is not completed, Sterling would have to recognize these expenses without realizing the expected benefits of the Merger.

The merger agreement limits Sterling's ability to pursue acquisition proposals and requires Sterling to pay a termination fee of \$75 million under limited circumstances relating to alternative acquisition proposals. Additionally, these and other provisions of the merger agreement, Sterling's articles of incorporation and bylaws and Washington law may deter potential acquirers. The merger agreement prohibits Sterling and Umpqua from soliciting, initiating, knowingly encouraging or knowingly facilitating certain third party acquisition proposals. The merger agreement also provides that Sterling must pay a termination fee in the amount of \$75 million in the event that the merger agreement is terminated under certain circumstances, including a termination resulting from Sterling's failure to abide by certain obligations not to solicit acquisition proposals. Further, the merger agreement also prohibits Sterling from waiving confidentiality and standstill provisions in its favor in existing agreements with third parties. These provisions may discourage or prohibit, as applicable, a potential competing acquirer that might have an interest in acquiring all or a significant part of Sterling from considering or proposing such an acquisition. In addition, under Washington law, certain business combinations involving Sterling with its large shareholders are restricted without the approval of the board of directors of Sterling.

These provisions and agreements, and other provisions of Sterling's articles of incorporation or bylaws or of the Washington Business Corporation Act, could make it more difficult for a third party to acquire control of Sterling or may discourage a potential competing acquirer.

Item 2 Unregistered Sales of Equity Securities and Use of Proceeds

Not applicable.

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.

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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, 2013

Date

STERLING FINANCIAL CORPORATION  
(Registrant)

By: /s/ Robert G. Butterfield

Robert G. Butterfield

Senior Vice President, Controller, and

Principal Accounting Officer

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Exhibit No. Exhibit Index

- 2.1 Agreement and Plan of Merger, dated as of September 11, 2013, between Sterling Financial Corporation and Umpqua Holdings Corporation. Filed as Exhibit 2.1 to Sterling's Current Report on form 8-K dated September 17, 2013, and incorporated by reference herein.
- 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

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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.

4.4 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.

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

10.1 Investor Letter Agreement, dated as of September 11, 2013, among Sterling Financial Corporation, Umpqua Holdings Corporation and Thomas H. Lee Equity Fund VI, L.P., Thomas H. Lee Parallel Fund VI, L.P. and Thomas H. Lee Parallel (DT) Fund VI, L.P. Filed as Exhibit 10.1 to Sterling's Current Report on Form 8-K dated September 17, 2013, and incorporated by reference herein.

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Exhibit No. Exhibit Index

- 10.2 Investor Letter Agreement, dated as of September 11, 2013, among Sterling Financial Corporation, Umpqua Holdings Corporation and Warburg Pincus Private Equity X, L.P. and Warburg Pincus X Partners, L.P. Filed as Exhibit 10.2 to Sterling's Current Report on Form 8-K dated September 17, 2013, and incorporated by reference herein.
- 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.