

HERITAGE COMMERCE CORP  
Form 10-K  
March 07, 2014

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

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**FORM 10-K**

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(MARK ONE)

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

For the fiscal year ended December 31, 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 000-23877

**Heritage Commerce Corp**

*(Exact name of Registrant as Specified in its Charter)*

**California**  
*(State or Other Jurisdiction of  
Incorporation or Organization)*

**77-0469558**  
*(I.R.S. Employer  
Identification Number)*

**150 Almaden Boulevard  
San Jose, California 95113**  
*(Address of Principal Executive Offices including Zip Code)*

**(408) 947-6900**  
*(Registrant's Telephone Number, Including Area Code)*  
**Securities registered pursuant to Section 12(b) of the Act:**

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| Title of Each Class        | Name of Each Exchange on which Registered                    |
|----------------------------|--|
| Common Stock, no par value | The NASDAQ Stock Market LLC<br>(NASDAQ Global Select Market) |

### Securities registered pursuant to Section 12(g) of the Act: None

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

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

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

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

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

|  |   |   |  |
|--|---|---|--|
| Large accelerated<br>filer <input type="radio"/> | Accelerated filer<br><input checked="" type="radio"/> | Non-accelerated<br>filer <input type="radio"/>      | Smaller reporting<br>company <input type="radio"/> |
|  |   | (Do not check if a<br>smaller reporting<br>company) |  |

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

The aggregate market value of the common stock held by non-affiliates of the Registrant as of June 30, 2013, based upon the closing price on that date of \$7.00 per share as reported on the NASDAQ Global Select Market, and 17,460,897 shares held, was approximately \$122.2 million.

As of February 7, 2014, there were 26,350,938 shares of the Registrant's common stock (no par value) outstanding.

### DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's definitive proxy statement to be filed with the Securities and Exchange Commission pursuant to Regulation 14A in connection with the 2014 Annual Meeting of Shareholders to be held on May 22, 2014 are incorporated by reference into Part III of this Report. The proxy statement will be filed with the Securities and Exchange Commission not later than 120 days after the Registrant's fiscal year ended December 31, 2013.

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**Cautionary Note Regarding Forward-Looking Statements**

This Report on Form 10-K contains various statements that may constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, Rule 175 promulgated thereunder, and Section 21E of the Securities Exchange Act of 1934, as amended, Rule 3b-6 promulgated thereunder and are intended to be covered by the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Any statements about our expectations, beliefs, plans, objectives, assumptions or future events or performance are not historical facts and may be forward-looking. These forward-looking statements often can be, but are not always, identified by the use of words such as "assume," "expect," "intend," "plan," "project," "believe," "estimate," "predict," "anticipate," "may," "might," "should," "could," "goal," "potential" and similar expressions. We base these forward-looking statements on our current expectations and projections about future events, our assumptions regarding these events and our knowledge of facts at the time the statements are made. These statements include statements relating to our projected growth, anticipated future financial performance, and management's long-term performance goals, as well as statements relating to the anticipated effects on results of operations and financial condition.

These forward-looking statements are subject to various risks and uncertainties that may be outside our control and our actual results could differ materially from our projected results. In addition, our past results of operations do not necessarily indicate our future results. The forward-looking statements could be affected by many factors, including but not limited to:

Local, regional, and national economic conditions and events and the impact they may have on us and our customers, and our assessment of that impact on our estimates including, the allowance for loan losses;

Continued delay in the pace of economic recovery and continued stagnant or decreasing employment levels;

Changes in the financial performance or condition of the Company's customers, or changes in the performance or creditworthiness of our customers' suppliers or other counterparties, which could lead to decreased loan utilization rates, delinquencies, or defaults and could negatively affect our customers' ability to meet certain credit obligations;

Volatility in credit and equity markets and its effect on the global economy;

Changes in consumer spending, borrowings and saving habits;

Competition for loans and deposits and failure to attract or retain deposits and loans;

The ability to increase market share and control expenses;

Risks associated with concentrations in real estate related loans;

Other-than-temporary impairment charges to our securities portfolio;

An oversupply of inventory and deterioration in values of California commercial real estate;

A prolonged slowdown in construction activity;

Changes in the level of nonperforming assets and charge-offs and other credit quality measures, and their impact on the adequacy of the Company's allowance for loan losses and the Company's provision for loan losses;

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The effects of and changes in trade, monetary and fiscal policies and laws, including the interest rate policies of the Federal Open Market Committee of the Federal Reserve Board;

Changes in inflation, interest rates, and market liquidity which may impact interest margins and impact funding sources;

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Our ability to raise capital or incur debt on reasonable terms;

Regulatory limits on Heritage Bank of Commerce's ability to pay dividends to the Company;

The impact of reputational risk on such matters as business generation and retention, funding and liquidity;

The impact of cyber security attacks or other disruptions to the Company's information systems and any resulting compromise of data or disruptions in service;

The effect of the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and the rules and regulations to be promulgated by supervisory and oversight agencies implementing the new legislation, taking into account that the precise timing, extent and nature of such rules and regulations and the impact on the Company are uncertain;

The impact of revised capital requirements under Basel III;

Significant changes in applicable laws and regulations, including those concerning taxes, banking and securities;

Changes in the competitive environment among financial or bank holding companies and other financial service providers;

The effect of changes in accounting policies and practices, as may be adopted by the regulatory agencies, as well as the Public Company Accounting Oversight Board, the Financial Accounting Standards Board and other accounting standard setters;

The costs and effects of legal and regulatory developments, including resolution of legal proceedings or regulatory or other governmental inquiries, and the results of regulatory examinations or reviews; and

Our success in managing the risks involved in the foregoing items.

We are not able to predict all the factors that may affect future results. You should not place undue reliance on any forward looking statement, which speaks only as of the date of this Report on Form 10-K. Except as required by applicable laws or regulations, we do not undertake any obligation to update or revise any forward looking statement, whether as a result of new information, future events or otherwise.

## **PART I**

### **ITEM 1 BUSINESS**

#### **General**

Heritage Commerce Corp, a California corporation organized in 1997, is a bank holding company registered under the Bank Holding Company Act of 1956, as amended. We provide a wide range of banking services through Heritage Bank of Commerce, our wholly-owned subsidiary and our principal asset. Heritage Bank of Commerce is a California state-chartered bank headquartered in San Jose, California and has been conducting business since 1994.

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Heritage Bank of Commerce is a multi-community independent bank that offers a full range of commercial banking services to small and medium-sized businesses and their owners, managers and employees. We operate through 10 full service branch offices located entirely in the southern and eastern regions of the general San Francisco Bay Area of California in the counties of Santa Clara, Alameda, and Contra Costa. Our market includes the headquarters of a number of technology based companies in the region commonly known as "Silicon Valley."

Our lending activities are diversified and include commercial, real estate, construction and land development, consumer and Small Business Administration ("SBA") guaranteed loans. We generally lend

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in markets where we have a physical presence through our branch offices and an SBA loan production office. We attract deposits throughout our market area with a customer-oriented product mix, competitive pricing, and convenient locations. We offer a wide range of deposit products for business banking and retail markets. We offer a multitude of other products and services to complement our lending and deposit services.

As a bank holding company, Heritage Commerce Corp is subject to the supervision of the Board of Governors of the Federal Reserve System (the "Federal Reserve"). We are required to file with the Federal Reserve reports and other information regarding our business operations and the business operations of our subsidiaries. As a California chartered bank, Heritage Bank of Commerce is subject to primary supervision, periodic examination, and regulation by the Department of Business Oversight Division of Financial Institutions ("DFI"), and by the Federal Reserve, as its primary federal regulator.

Our principal executive office is located at 150 Almaden Boulevard, San Jose, California 95113, telephone number: (408) 947-6900.

At December 31, 2013, we had consolidated assets of \$1.49 billion, deposits of \$1.29 billion and shareholders' equity of \$173.4 million.

When we use "we", "us", "our" or the "Company", we mean the Company on a consolidated basis with Heritage Bank of Commerce. When we refer to "HCC" or the "holding company", we are referring to Heritage Commerce Corp on a standalone basis. When we use "HBC", we mean Heritage Bank of Commerce on a standalone basis.

The Internet address of the Company's website is "<http://www.heritagecommercecorp.com>." The Company makes available free of charge through the Company's website, the Company's annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to these reports. The Company makes these reports available on its website on the same day they appear on the Securities and Exchange Commission's ("SEC") website.

## **Heritage Bank of Commerce**

HBC is a California state-chartered bank headquartered in San Jose, California. It was incorporated in November 1993 and opened for business in January 1994. HBC operates through ten full service branch offices. The locations of HBC's current offices are:

|           |   |              |   |
|-----------|---|--------------|---|
| San Jose: | Administrative Office<br>Main Branch<br>150 Almaden Boulevard<br>San Jose, CA 95113 | Los Gatos:   | Branch Office<br>15575 Los Gatos Boulevard<br>Building B<br>Los Gatos, CA 95032 |
| Danville: | Branch Office<br>387 Diablo Road<br>Danville, CA 94526                              | Morgan Hill: | Branch Office<br>18625 Sutter Boulevard<br>Morgan Hill, CA 95037                |
| Fremont:  | Branch Office<br>3137 Stevenson Boulevard<br>Fremont, CA 94538                      | Pleasanton:  | Branch Office<br>300 Main Street<br>Pleasanton, CA 94566                        |
| Gilroy:   | Branch Office<br>7598 Monterey Street<br>Suite 110<br>Gilroy, CA 95020              | Sunnyvale:   | Branch Office<br>333 W. El Camino Real<br>Sunnyvale, CA 94087                   |



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|            |  |               |   |
|------------|--|---------------|---|
| Los Altos: | Branch Office<br>419 South San Antonio Road<br>Los Altos, CA 95032 | Walnut Creek: | Branch Office<br>101 Ygnacio Valley Road<br>Suite 100<br>Walnut Creek, CA 94596 |
|------------|--|---------------|---|

HBC also has a loan production office located at 851 Sterling Parkway, Lincoln, California 95648. HBC is a full-service community bank offering an array of banking products and services to the communities it serves, including accepting time and demand products and originating commercial loans, commercial real estate loans, construction loans, and small business and consumer loans.

### *Lending Activities*

Our commercial loan portfolio is comprised of operating secured and unsecured loans advanced for working capital, equipment purchases and other business purposes. Generally short-term loans have maturities ranging from thirty days to one year, and "term loans" have maturities ranging from one to five years. Short-term business loans are generally intended to finance current transactions and typically provide for periodic principal payments, with interest payable monthly. Term loans generally provide for floating or fixed interest rates, with monthly payments of both principal and interest. Repayment of secured and unsecured commercial loans depends substantially on the borrower's underlying business, financial condition and cash flows, as well as the sufficiency of the collateral. Compared to real estate, the collateral may be more difficult to monitor, evaluate and sell. It may also depreciate more rapidly than real estate. Such risks can be significantly affected by economic conditions. HBC's commercial loans are primarily originated for locally-oriented commercial activities in communities where HBC has a physical presence through its branch offices and a loan production office.

HBC actively engages in SBA lending. HBC has been designated as an SBA Preferred Lender since 1999.

The commercial real estate loan portfolio is comprised of loans secured by commercial real estate. These loans are generally advanced based on the borrower's cash flow, and the underlying collateral provides a secondary source of payment. HBC generally restricts real estate term loans to no more than 75% of the property's appraised value or the purchase price of the property, depending on the type of property and its utilization. HBC offers both fixed and floating rate loans. Maturities on such loans are generally restricted to between five and ten years (with amortization ranging from fifteen to twenty-five years and a balloon payment due at maturity, and amortization of thirty years on loans secured by apartments); however, SBA and certain real estate loans that can be sold in the secondary market may be advanced for longer maturities. Commercial real estate loans typically involve large balances to single borrowers or groups of related borrowers. Since payments on these loans are often dependent on the successful operation or management of the properties, as well as the business and financial condition of the borrower, repayment of such loans may be subject to adverse conditions in the real estate market, adverse economic conditions or changes in applicable government regulations. If the cash flow from the project decreases, or if leases are not obtained or renewed, the borrower's ability to repay the loan may be impaired.

We make commercial construction loans for rental properties, commercial buildings and homes built by developers on speculative, undeveloped property. We also make construction loans for homes built by owner occupants. The terms of commercial construction loans are made in accordance with our loan policy. Advances on construction loans are made in accordance with a schedule reflecting the cost of construction, but are generally limited to a 75% loan-to-completed-appraised-value ratio. Repayment of construction loans on non-residential properties is normally expected from the property's eventual rental income, income from the borrower's operating entity or the sale of the subject property. In the case of income-producing property, repayment is usually expected from permanent financing upon completion of construction. At times we provide the permanent mortgage financing on our construction loans on income-

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producing property. Construction loans are interest-only loans during the construction period, which typically do not exceed 18 months. If HBC provides permanent financing the short-term loan converts to permanent, amortizing financing following the completion of construction. Generally, before making a commitment to fund a construction loan, we require an appraisal of the property by a state-certified or state-licensed appraiser. We review and inspect properties before disbursement of funds during the term of the construction loan. The repayment of construction loans is dependent upon the successful and timely completion of the construction of the subject property, as well as the sale of the property to third parties or the availability of permanent financing upon completion of all improvements. Construction loans expose us to the risk that improvements will not be completed on time, and in accordance with specifications and projected costs. Construction delays, the financial impairment of the builder, interest rate increases or economic downturn may further impair the borrower's ability to repay the loan. In addition, the borrower may not be able to obtain permanent financing or ultimate sale or rental of the property may not occur as anticipated. HBC utilizes underwriting guidelines to assess the likelihood of repayment from sources such as sale of the property or permanent mortgage financing prior to making the construction loan.

Our home equity line loan portfolio is comprised of home equity lines of credit to customers in our markets. Home equity lines of credit are underwritten in a manner such that they result in credit risk that is substantially similar to that of residential mortgage loans. Nevertheless, home equity lines of credit have greater credit risk than residential mortgage loans because they are often secured by mortgages that are subordinated to the existing first mortgage on the property, which we may or may not hold, and they are not covered by private mortgage insurance coverage.

The consumer loan portfolio is composed of miscellaneous consumer loans including loans for financing automobiles, various consumer goods and other personal purposes. Consumer loans are generally secured. Repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment for the outstanding loan, and the remaining deficiency may not warrant further substantial collection efforts against the borrower. In addition, consumer loan collections are dependent on the borrower's continued financial stability, which can be adversely affected by job loss, divorce, illness or personal bankruptcy. Furthermore, the application of various federal and state laws, including federal and state bankruptcy and insolvency laws, may limit the amount which can be recovered on such loans.

As of December 31, 2013, the percentage of our total loans for each of the principal areas in which we directed our lending activities were as follows: (i) commercial and industrial 43% (including SBA loans); (ii) real estate secured loans 46%; (iii) land and construction loans 3%; and (iv) consumer (including home equity) 8%. While no specific industry concentration is considered significant, our lending operations are located in market areas dependent on technology and real estate industries and their supporting companies.

***Investments***

Our investment policy is established by the Board of Directors. The general investment strategies are developed and authorized by our Finance and Investment Committee of the Board of Directors. The investment policy is reviewed annually by the Finance and Investment Committee, and any changes to the policy are subject to approval by the full Board of Directors. The overall objectives of the investment policy are to maintain a portfolio of high quality and diversified investments to maximize interest income over the long term and to minimize risk, to provide collateral for borrowings, and to provide additional earnings when loan production is low. The policy dictates that investment decisions take into consideration the safety of principal, liquidity requirements and interest rate risk management. All securities transactions are reported to the Board of Directors' Finance and Investment Committee on a monthly basis.

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***Sources of Funds***

Deposits traditionally have been our primary source of funds for our investment and lending activities. We also are able to borrow from the Federal Home Loan Bank of San Francisco and the Federal Reserve Bank of San Francisco to supplement cash flow needs. Our additional sources of funds are scheduled loan payments, maturing investments, loan repayments, income on other earning assets, and the proceeds of loan sales and securities sales.

Interest rates, maturity terms, service fees and withdrawal penalties are established on a periodic basis. Deposit rates and terms are based primarily on current operating strategies and market interest rates, liquidity requirements and our deposit growth goals.

We offer a wide range of deposit products for retail and business banking markets including checking accounts, interest-bearing transaction accounts, savings accounts, time deposits and retirement accounts. Our branch network enables us to attract deposits from throughout our market area with a customer-oriented product mix, competitive pricing, and convenient locations. HBC joined the Certificate of Deposit Account Registry Service (CDARS®) program in August 2008, which enables our local customers to obtain expanded FDIC insurance coverage on their deposits.

***Other Banking Services***

We offer a multitude of other products and services to complement our lending and deposit services. These include cashier's checks, traveler's checks, bank-by-mail, ATMs, night depositories, safe deposit boxes, direct deposit, automated payroll services, electronic funds transfers, online banking, online bill pay, and other customary banking services. HBC currently operates ATMs at five different locations. In addition, we have established a convenient customer service group accessible by toll-free telephone to answer questions and promote a high level of customer service. HBC does not have a trust department. In addition to the traditional financial services offered, HBC offers remote deposit capture, automated clearing house origination, electronic data interchange and check imaging. HBC continues to investigate products and services that it believes addresses the growing needs of its customers and to analyze other markets for potential expansion opportunities.

**U.S. Treasury Capital Purchase Program**

On November 21, 2008, HCC issued 40,000 shares of Series A Fixed Rate Cumulative Perpetual Preferred Stock ("Series A Preferred Stock") to the U.S. Treasury under the terms of the U.S. Treasury Capital Purchase Program for \$40.0 million with a liquidation preference of \$1,000 per share. In addition, HCC issued a warrant to the U.S. Treasury to purchase 462,963 shares of HCC's common stock.

On March 7, 2012, the Company repurchased all of the Series A Preferred Stock in the aggregate amount of \$40 million and paid a final dividend to the U.S. Treasury in the amount of \$122,000. On June 12, 2013, the Company completed the repurchase of the common stock warrant for \$140,000.

For complete discussion and disclosure see "*Item 7 Management Discussion and Analysis of Financial Condition and Results of Operations Capital Resources*" presented elsewhere in this report.

**2010 Private Placement**

On June 21, 2010, HCC issued to various institutional investors 53,996 shares of Series B Mandatorily Convertible Cumulative Perpetual Preferred Stock ("Series B Preferred Stock") and 21,004 shares of Series C Convertible Perpetual Preferred Stock ("Series C Preferred Stock") for an aggregate purchase price of \$75 million. The Series B Preferred Stock was convertible into common stock at a conversion price of \$3.75 per share. The Series C Preferred Stock is mandatorily convertible into common stock at a conversion price of \$3.75 per share upon a subsequent transfer of the Series C Preferred Stock to third parties not affiliated with the holder in a widely dispersed offering. On September 16, 2010, the Series B

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Preferred Stock in accordance with its terms was converted into 14,398,992 shares of common stock of HCC. The Series C Preferred Stock remains outstanding and is convertible into 5,601,000 shares of common stock. The Series C Preferred Stock is non-voting except in the case of certain transactions that would affect the rights of the holders of the Series C Preferred Stock or applicable law. Holders of Series C Preferred Stock will receive dividends if and only to the extent dividends are paid to holders of common stock. The Series C Preferred Stock is not redeemable by HCC or by the holders and has a liquidation preference of \$1,000 per share. The Series C Preferred Stock ranks senior to HCC's common stock.

**Correspondent Banks**

Correspondent bank deposit accounts are maintained to enable the Company to transact types of activity that it would otherwise be unable to perform or would not be cost effective due to the size of the Company or volume of activity. The Company has utilized several correspondent banks to process a variety of transactions.

**Competition**

The banking and financial services business in California generally, and in the Company's market areas specifically, is highly competitive. The industry continues to consolidate and unregulated competitors have entered banking markets with products targeted at highly profitable customer segments. Many larger unregulated competitors are able to compete across geographic boundaries, and provide customers with meaningful alternatives to most significant banking services and products. These consolidation trends are likely to continue. The increasingly competitive environment is a result primarily of changes in regulation, changes in technology and product delivery systems, and the consolidation among financial service providers.

With respect to commercial bank competitors, the business is dominated by a relatively small number of major banks that operate a large number of offices within our geographic footprint. For the combined Santa Clara, Alameda and Contra Costa county region, the three counties within which the Company operates, the top three institutions are all multi-billion dollar entities with an aggregate of 271 offices that control a combined 54.54% of deposit market share based on June 30, 2013 FDIC market share data. HBC ranks sixteenth with 0.81% share of total deposits based on June 30, 2013 market share data. These banks have, among other advantages, the ability to finance wide-ranging advertising campaigns and to allocate their resources to regions of highest yield and demand. Larger banks are seeking to expand lending to small businesses, which are traditionally community bank customers. They can also offer certain services that we do not offer directly, but may offer indirectly through correspondent institutions. By virtue of their greater total capitalization, these banks also have substantially higher lending limits than we do. For customers whose needs exceed our legal lending limit, we arrange for the sale, or "participation," of some of the balances to financial institutions that are not within our geographic footprint.

In addition to other large regional banks and local community banks, our competitors include savings institutions, securities and brokerage companies, asset management groups, mortgage banking companies, credit unions, finance and insurance companies, internet-based companies, and money market funds. In recent years, we have also witnessed increased competition from specialized companies that offer wholesale finance, credit card, and other consumer finance services, as well as services that circumvent the banking system by facilitating payments via the internet, wireless devices, prepaid cards, or other means. Technological innovations have lowered traditional barriers of entry and enabled many of these companies to compete in financial services markets. Such innovation has, for example, made it possible for non-depository institutions to offer customers automated transfer payment services that previously were considered traditional banking products. In addition, many customers now expect a choice of delivery channels, including telephone and smart phones, mail, personal computer, ATMs, self-service branches, and/or in-store branches.

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Strong competition for deposits and loans among financial institutions and non-banks alike affects interest rates and other terms on which financial products are offered to customers. Mergers between financial institutions have placed additional pressure on other banks within the industry to remain competitive by streamlining operations, reducing expenses, and increasing revenues. Competition has also intensified due to federal and state interstate banking laws enacted in the mid-1990's, which permit banking organizations to expand into other states. The relatively large and expanding California market has been particularly attractive to out of state institutions. The Gramm-Leach-Bliley Act of 1999 has made it possible for full affiliations to occur between banks and securities firms, insurance companies, and other financial companies, and has also intensified competitive conditions. See Item 1 "Business Supervision and Regulation Heritage Commerce Corp Financial Modernization".

In order to compete with the other financial service providers, the Company principally relies upon community-oriented, personalized service, local promotional activities, personal relationships established by officers, directors, and employees with its customers, and specialized services tailored to meet its customers' needs. Our "preferred lender" status with the Small Business Administration allows us to approve SBA loans faster than many of our competitors. In those instances where the Company is unable to accommodate a customer's needs, the Company seeks to arrange for such loans on a participation basis with other financial institutions or to have those services provided in whole or in part by its correspondent banks. See Item 1 "Business Correspondent Banks."

**Economic Conditions, Government Policies, Legislation, and Regulation**

The Company's profitability, like most financial institutions, is primarily dependent on interest rate differentials. In general, the difference between the interest rates paid by HBC on interest-bearing liabilities, such as deposits and other borrowings, and the interest rates received by HBC on interest earning assets, such as loans extended to customers and securities held in the investment portfolio, will comprise the major portion of the Company's earnings. These rates are highly sensitive to many factors that are beyond the control of the Company and HBC, such as inflation, recession and unemployment, and the impact which future changes in domestic and foreign economic conditions might have on the Company cannot be predicted.

The Company's business is also influenced by the monetary and fiscal policies of the federal government and the policies of regulatory agencies, particularly the Board of Governors of the Federal Reserve Board. The Federal Reserve implements national monetary policies (with objectives such as curbing inflation and combating recession) through its open-market operations in U.S. Government securities by adjusting the required level of reserves for depository institutions subject to its reserve requirements, and by varying the target Federal funds and discount rates applicable to borrowings by depository institutions. The actions of the Federal Reserve in these areas influence the growth of bank loans, investments, and deposits and also affect interest earned on interest earning assets and paid on interest bearing liabilities. The nature and impact of any future changes in monetary and fiscal policies on the Company cannot be predicted.

From time to time, federal and state legislation is enacted which may have the effect of materially increasing the cost of doing business, limiting or expanding permissible activities, or affecting the competitive balance between banks and other financial services providers. In addition, the various bank regulatory agencies often adopt new rules and regulations and policies to implement and enforce existing legislation. It cannot be predicted whether, or in what form, any such legislation or regulations or changes in policy may be enacted or the extent to which the business of the Company would be affected thereby. The Company cannot predict whether or when potential legislation will be enacted and, if enacted, the effect that it, or any implemented regulations and supervisory policies, would have on our financial condition or results of operations. In addition, the outcome of any examination, litigation or investigation initiated by state or federal authorities may result in necessary changes in our operations and increased compliance costs.

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*The Dodd-Frank Wall Street Reform and Consumer Protection Act*

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, as amended ("Dodd-Frank"), significantly revised and expanded the rulemaking, supervisory and enforcement authority of the federal bank regulatory agencies. Dodd-Frank followed the Emergency Economic Stabilization Act of 2008 and the American Recovery and Reinvestment Act of 2009 in response to the economic downturn and financial industry instability that commenced in 2008. Dodd-Frank impacts many aspects of the financial industry and, in many cases, will impact larger and smaller financial institutions and community banks differently over time. Many of the following key provisions of Dodd-Frank affecting the financial industry are now effective or are in the proposed rule or implementation stage:

the creation of a Financial Services Oversight Counsel to identify emerging systemic risks and improve inter-agency cooperation;

expanded FDIC authority to conduct the orderly liquidation of certain systemically significant non-bank financial companies in addition to depository institutions;

the establishment of strengthened capital and liquidity requirements for banks and bank holding companies, including minimum leverage and risk-based capital requirements no less than the strictest requirements in effect for depository institutions as of the date of enactment;

enhanced regulation of financial markets, including the derivative and securitization markets, and the elimination of certain proprietary trading activities by banks (the "Volcker Rule");

requirement by statute that bank holding companies serve as a source of financial strength for their depository institution subsidiaries;

the elimination and phase out of trust preferred securities from Tier 1 capital with certain exceptions;

a permanent increase of the previously implemented temporary increase of FDIC deposit insurance to \$250,000;

authorization for financial institutions to pay interest on business checking accounts;

changes in the calculation of FDIC deposit insurance assessments, such that the assessment base will no longer be the institution's deposit base, but instead, is the institutions average consolidated total assets less its average tangible equity, as a result of which smaller banks are now paying proportionately less and larger banks proportionately more of the aggregate insurance assessments;

the elimination of remaining barriers to de novo interstate branching by banks;

expanded restrictions on transactions with affiliates and insiders under Section 23A and 23B of the Federal Reserve Act, and lending limits for derivative transactions, repurchase agreements and securities lending and borrowing transactions;

the transfer of oversight of federally chartered thrift institutions to the Office of the Comptroller of the Currency and state-chartered savings banks to the FDIC, and the elimination of the Office of Thrift Supervision;

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provisions that affect corporate governance and executive compensation at most United States publicly traded companies, including proxy access requirements for stockholders, non-binding shareholders votes on executive compensation, independence requirements for compensation committees, enhance executive compensation disclosures and compensation claw-backs;

the creation of a Consumer Financial Protection Bureau, which is authorized to promulgate and enforce consumer protection regulations relating to bank and non-bank financial products and examine and enforce these regulations on banks with more than \$10 billion in assets;

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Requirements that fees of debit card issuers be reasonable and proportional to costs incurred, which does not apply directly to banks with less than \$10 billion in assets, but nonetheless affects smaller banks due to competitive factors.

**Supervision and Regulation**

*Introduction*

Banking is a complex, highly regulated industry. Regulation and supervision by federal and state banking agencies are intended to maintain a safe and sound banking system, protect depositors and the Federal Deposit Insurance Corporation's ("FDIC") insurance fund, and to facilitate the conduct of sound monetary policy. In furtherance of these goals, Congress and the states have created several largely autonomous regulatory agencies and enacted numerous laws that govern banks, bank holding companies and the financial services industry. Consequently, the growth and earnings performance of the Company can be affected not only by management decisions and general economic conditions, but also by the requirements of applicable state and federal statutes, regulations and the policies of various governmental regulatory authorities, including the Federal Reserve, FDIC, and the DFI.

The system of supervision and regulation applicable to financial services businesses governs most aspects of the business of the Company, including: (i) the scope of permissible business; (ii) investments; (iii) reserves that must be maintained against deposits; (iv) capital levels that must be maintained; (v) the nature and amount of collateral that may be taken to secure loans; (vi) the establishment of new branches; (vii) mergers and consolidations with other financial institutions; and (viii) the payment of dividends.

Set forth below is a description of the significant elements of the laws and regulations applicable to HCC and HBC. The description is qualified in its entirety by reference to the full text of the statutes, regulations and policies that are described. Also, such statutes, regulations and policies are continually under review by the U.S. Congress and state legislatures and federal and state regulatory agencies. A change in statutes, regulations or regulatory policies applicable to HCC or HBC could have a material effect on our business.

*Heritage Commerce Corp*

*General.* As a bank holding company, HCC is registered under the Bank Holding Company Act of 1956, as amended ("BHCA"), and is subject to regulation and periodic examination by the Federal Reserve. HCC is also required to file periodic reports of its operations and any additional information regarding its activities and those of its subsidiaries as may be required by the Federal Reserve.

HCC is also a bank holding company within the meaning of Section 1280 of the California Financial Code. Consequently, HCC is subject to examination by, and may be required to file reports with, the DFI. DFI approval may be required for certain mergers and acquisitions.

HCC's stock is traded on the NASDAQ Global Select Market (under the trading symbol "HTBK"), and HCC is subject to rules and regulations of The NASDAQ Stock Market, including those related to corporate governance. HCC is also subject to the periodic reporting requirements of Section 13 of the Securities Exchange Act of 1934 (the "Exchange Act") which requires HCC to file annual, quarterly and other current reports with the SEC. HCC is subject to additional regulations including, but not limited to, the proxy and tender offer rules promulgated by the SEC under Sections 13 and 14 of the Exchange Act, the reporting requirements of directors, executive officers and principal shareholders regarding transactions in the HCC's common stock and short swing profits rules promulgated by the SEC under Section 16 of the Exchange Act, and certain additional reporting requirements by principal shareholders of HCC promulgated by the SEC under Section 13 of the Exchange Act.

*The Sarbanes Oxley Act of 2002.* The Sarbanes Oxley Act of 2002 ("SOX") became effective on July 30, 2002, and is intended to provide a permanent framework that improves the quality of independent



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audits and accounting services, improves the quality of financial reporting, strengthens the independence of accounting firms and increases the responsibility of management for corporate disclosures and financial statements.

SOX's provisions are significant to all companies that have a class of securities registered under Section 12 of the Exchange Act, or are otherwise reporting to the SEC (or the appropriate federal banking agency) pursuant to Section 15(d) of the Exchange Act, including HCC (collectively, "public companies"). In addition to SEC rulemaking to implement SOX, The NASDAQ Stock Market has adopted corporate governance rules intended to allow shareholders to more easily and effectively monitor the performance of companies and directors. The principal provisions of SOX provide for and include, among other things: (i) the creation of an independent accounting oversight board; (ii) auditor independence provisions that restrict non-audit services that accountants may provide to their audit clients; (iii) additional corporate governance and responsibility measures, including the requirement that the chief executive officer and chief financial officer of a public company certify financial statements; (iv) the forfeiture of bonuses or other incentive based compensation and profits from the sale of a public company's securities by directors and senior officers in the twelve month period following initial publication of any financial statements that later require restatement; (v) an increase in the oversight of, and enhancement of certain requirements relating to, audit committees of public companies and how they interact with the public company's independent auditors; (vi) requirements that audit committee members must be independent and are barred from accepting consulting, advisory or other compensatory fees from the public company; (vii) requirements that public companies disclose whether at least one member of the audit committee is a "financial expert" (as such term is defined by the SEC) and if not discuss, why the audit committee does not have a financial expert; (viii) expanded disclosure requirements for corporate insiders, including accelerated reporting of stock transactions by insiders and a prohibition on insider trading during pension blackout periods; (ix) a prohibition on personal loans to directors and officers, except certain loans made by insured financial institutions on non-preferential terms and in compliance with other bank regulatory requirements; (x) disclosure of a code of ethics and filing a Form 8-K for a change or waiver of such code; (xi) a range of enhanced penalties for fraud and other violations; and (xii) expanded disclosure and certification relating to a public company's disclosure controls and procedures and internal controls over financial reporting.

*Affiliate Transactions.* HCC and HBC are deemed affiliates of each other within the meaning of the Federal Reserve Act, and transactions between affiliates are subject to Sections 23A and 23B of the Federal Reserve Act. The Federal Reserve Board has also issued Regulation W, which codifies prior regulations under Sections 23A and 23B of the Federal Reserve Act and related interpretive guidance with respect to affiliate transactions. Generally, Sections 23A and 23B: (i) limit the extent to which a financial institution or its subsidiaries may engage in covered transactions (A) with an affiliate (as defined in such sections) to an amount equal to 10% of such institution's capital and surplus; and (B) with all affiliates, in the aggregate to an amount equal to 20% of such capital and surplus; and (ii) require all transactions with an affiliate, whether or not covered transactions, to be on terms substantially the same, or at least as favorable to the institution or subsidiary, as the terms provided or that would be provided to a non-affiliate. Dodd-Frank enhances the requirements for certain transactions with affiliates under Sections 23A and 23B, including an expansion of the definition of "covered transactions" and increasing the amount of time for which collateral requirements regarding covered transactions must be maintained. The term "covered transaction" includes the making of loans, purchase of assets, issuance of a guarantee and other similar types of transactions.

*Source of Strength Doctrine.* Federal Reserve policy requires bank holding companies to act as a source of financial and managerial strength to their subsidiary banks. Under this policy, the holding company is expected to commit resources to support its bank subsidiary, including at times when the holding company may not be in a financial position to provide it. It is the Federal Reserve's position that bank holding companies should stand ready to use their available resources to provide adequate capital to

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their subsidiary banks during periods of financial stress or adversity. Bank holding companies must also maintain the financial flexibility and capital raising capacity to obtain additional resources for assisting their subsidiary bank. A bank holding company's failure to meet its source-of-strength obligations may constitute an unsafe and unsound practice or a violation of the Federal Reserve Board's regulations, or both. The source-of-strength doctrine most directly affects bank holding companies where a bank holding company's subsidiary bank fails to maintain adequate capital levels. In such a situation, the subsidiary bank will be required by the bank's federal regulator to take "prompt corrective action." Any capital loans by a bank holding company to its subsidiary bank are subordinate in right of payment to deposits and to certain other indebtedness of such subsidiary bank. The BHCA provides that, in the event of a bank holding company's bankruptcy, any commitment by the bank holding company to a federal bank regulatory agency to maintain the capital of a bank subsidiary will be assumed by the bankruptcy trustee and entitled to priority of payment.

Under certain conditions, the Federal Reserve Board may conclude that certain actions of a bank holding company, such as a payment of a cash dividend, would constitute an unsafe and unsound banking practice. The Federal Reserve Board also has the authority to regulate the debt of bank holding companies, including the authority to impose interest rate ceilings and reserve requirements on such debt. Under certain circumstances, the Federal Reserve Board may require a bank holding company to file written notice and obtain its approval prior to purchasing or redeeming its equity securities, unless certain conditions are met.

Dodd-Frank has added additional guidance regarding the source of strength doctrine and had directed the regulatory agencies to promulgate new regulations to increase the capital requirements for bank holding companies to a level that matches those of banking institutions.

*Investments and Acquisition of other Banks.* Subject to certain exceptions, the BHCA and the Change in Bank Control Act of 1978, together with the applicable regulations, require Federal Reserve approval (or, depending on the circumstances, no notice of disapproval) prior to any person or company acquiring "control" of a bank or bank holding company. A conclusive presumption of control exists if an individual or company acquires the power, directly or indirectly, to direct the management or policies of an insured depository institution or to vote 25% or more of any class of voting securities of any insured depository institution. A rebuttable presumption of control exists if a person or company acquires 10% or more but less than 25% of any class of voting securities of an insured depository institution and either the institution has registered securities under the Exchange Act (such as the Company), or no other person will own a greater percentage of that class of voting securities immediately after the acquisition.

As a bank holding company, we are required to obtain prior approval from the Federal Reserve before: (i) acquiring all or substantially all of the assets of a bank or bank holding company; (ii) acquiring direct or indirect ownership or control of more than 5% of the outstanding voting stock of any bank or bank holding company (unless we own a majority of such bank's voting shares); or (iii) merging or consolidating with any other bank or bank holding company. In determining whether to approve a proposed bank acquisition, federal bank regulators will consider, among other factors, the effect of the acquisition on competition, the public benefits expected to be received from the acquisition, the projected capital ratios and levels on a post-acquisition basis, and the acquiring institution's record of addressing the credit needs of the communities it serves, including the needs of low and moderate income neighborhoods, consistent with the safe and sound operation of the bank under the Community Reinvestment Act of 1977 ("CRA").

*Tie-in Arrangements.* Federal law prohibits a bank holding company and any subsidiary banks from engaging in certain tie-in arrangements in connection with the extension of credit. Thus, for example, HBC may not extend credit, lease or sell property, or furnish any services, or fix or vary the consideration for any of the foregoing on the condition that: (i) the customer must obtain or provide some additional credit, property or services from or to HBC other than a loan, discount, deposit or trust services; (ii) the customer

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must obtain or provide some additional credit, property or service from or to HCC or HBC; or (iii) the customer must not obtain some other credit, property or services from competitors, except reasonable requirements to assure soundness of credit extended.

*Permitted Activities.* Bank holding companies are limited to managing or controlling banks, furnishing services to or performing services for its subsidiaries, and engaging in other activities that the Federal Reserve determines by regulation or order to be so closely related to banking or managing or controlling banks as to be a proper incident thereto. In determining whether a particular activity is permissible, the Federal Reserve must consider whether the performance of such an activity reasonably can be expected to produce benefits to the public that outweigh possible adverse effects. Possible benefits include greater convenience, increased competition, and gains in efficiency. Possible adverse effects include undue concentration of resources, decreased or unfair competition, conflicts of interest, and unsound banking practices. Despite prior approval, the Federal Reserve may order a bank holding company or its subsidiaries to terminate any activity or to terminate ownership or control of any subsidiary when the Federal Reserve has reasonable cause to believe that a serious risk to the financial safety, soundness or stability of any bank subsidiary of that bank holding company may result from such an activity.

*Financial Modernization.* The Gramm-Leach-Bliley Act (the "GLBA"), which became effective in March 2000, permits greater affiliation among banks, securities firms, insurance companies, and other companies under a new type of financial services company known as a "financial holding company." A financial holding company essentially is a bank holding company with significantly expanded powers. Financial holding companies are authorized by statute to engage in a number of financial activities previously impermissible for bank holding companies, including securities underwriting, dealing and market making; sponsoring mutual funds and investment companies; insurance underwriting and agency; and merchant banking activities. The GLBA also permits the Federal Reserve and the U.S. Treasury to authorize additional activities for financial holding companies if they are "financial in nature" or "incidental" to financial activities. A bank holding company may become a financial holding company if each of its subsidiary banks is "well capitalized," "well managed," and, except in limited circumstances, in satisfactory compliance with the CRA. A financial holding company must provide notice to the Federal Reserve within 30 days after commencing activities previously determined by statute or by the Federal Reserve and U.S. Treasury to be permissible. HCC has no present plans to become a financial holding company. In addition, HBC is subject to other provisions of the GLBA, including those relating to CRA, privacy and the safe-guarding of confidential customer information, regardless of whether HCC elects to become a financial holding company or to conduct activities through a financial subsidiary of HBC.

The Company does not believe that the GLBA has had, or will have in the near term, a material adverse effect on its operations. However, to the extent that it permits banks, securities firms, and insurance companies to affiliate, the financial services industry may experience further consolidation. The GLBA is intended to grant to community banks certain powers as a matter of right that larger institutions have accumulated on an ad hoc basis. Nevertheless, the GLBA may have the result of increasing the amount of competition from larger institutions and other types of companies offering financial products, many of which may have substantially more financial resources than HCC and HBC.

*Heritage Bank of Commerce*

*General.* As a California commercial bank whose deposits are insured by the FDIC, HBC is subject to regulation, supervision, and regular examination by the DFI and by the Federal Reserve, as HBC's primary Federal regulator, and must additionally comply with certain applicable regulations of the Federal Reserve. The regulations of those agencies govern most aspects of a bank's business. Specific federal and state laws and regulations which are applicable to banks regulate, among other things, the scope of their business, their investments, their reserves against deposits, the timing of the availability of deposited funds, their activities relating to dividends, investments, loans, the nature and amount of and collateral for certain

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loans, borrowings, capital requirements, certain check-clearing activities, branching, and mergers and acquisitions. California banks are also subject to statutes and regulations including Federal Reserve Regulation O and Federal Reserve Act Sections 23A and 23B and Regulation W, which restrict or limit loans or extensions of credit to "insiders", including officers, directors and principal shareholders, and loans or extension of credit by banks to affiliates or purchases of assets from affiliates, including parent bank holding companies, except pursuant to certain exceptions and terms and conditions at least as favorable to those prevailing for comparable transactions with unaffiliated parties

Pursuant to the Federal Deposit Insurance Act ("FDIA") and the California Financial Code, California state chartered commercial banks may generally engage in any activity permissible for national banks. Therefore, HBC may form subsidiaries to engage in the many so-called "closely related to banking" or "nonbanking" activities commonly conducted by national banks in operating subsidiaries or subsidiaries of bank holding companies. Further, pursuant to GLBA, California banks may conduct certain "financial" activities in a subsidiary to the same extent as may a national bank, provided the bank is and remains "well-capitalized," "well-managed" and in satisfactory compliance with the CRA.

HBC is a member of the Federal Home Loan Bank ("FHLB") of San Francisco. Among other benefits, each FHLB serves as a reserve or central bank for its members within its assigned region and makes available loans or advances to its members. Each FHLB is financed primarily from the sale of consolidated obligations of the FHLB system. As an FHLB member, HBC is required to own a certain amount of capital stock in the FHLB. At December 31, 2013, HBC was in compliance with the FHLB's stock ownership requirement. Federal Reserve stock is carried at cost and may be sold back to the Federal Reserve at its carrying value. Cash dividends received are reported as income.

*Depositor Preference.* In the event of the "liquidation or other resolution" of an insured depository institution, the claims of depositors of the institution, including the claims of the FDIC as subrogee of insured depositors, and certain claims for administrative expenses of the FDIC as a receiver, will have priority over other general unsecured claims against the institution. If an insured depository institution fails, insured and uninsured depositors, along with the FDIC, will have priority in payment ahead of unsecured, non-deposit creditors, including the parent bank holding company, with respect to any extensions of credit they have made to such insured depository institution.

*Community Reinvestment Act.* The CRA is intended to encourage insured depository institutions, while operating safely and soundly, to help meet the credit needs of their communities. The CRA specifically directs the federal bank regulatory agencies, in examining insured depository institutions, to assess their record of helping to meet the credit needs of their entire community, including low- and moderate-income neighborhoods, consistent with safe and sound banking practices. The CRA further requires the agencies to take a financial institution's record of meeting its community credit needs into account when evaluating applications for, among other things, domestic branches, consummating mergers or acquisitions, or holding company formations.

The federal banking agencies have adopted regulations which measure a bank's compliance with its CRA obligations on a performance based evaluation system. This system bases CRA ratings on an institution's actual lending service and investment performance rather than the extent to which the institution conducts needs assessments, documents community outreach or complies with other procedural requirements. The ratings range from "outstanding" to a low of "substantial noncompliance." HBC had a CRA rating of "satisfactory" as of its most recent regulatory examination.

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*Loans to Directors, Executive Officers and Principal Shareholders.* The authority of HBC to extend credit to our directors, executive officers and principal shareholders, including their immediate family members and corporations and other entities that they control, is subject to substantial restrictions and requirements under Sections 22(g) and 22(h) of the Federal Reserve Act and Regulation O promulgated thereunder, as well as the Sarbanes-Oxley Act of 2002. These statutes and regulations impose specific limits on the amount of loans our subsidiary bank may make to directors and other insiders, and specified approval procedures must be followed in making loans that exceed certain amounts. In addition, all loans HBC makes to directors and other insiders must satisfy the following requirements:

the loans must be made on substantially the same terms, including interest rates and collateral, as prevailing at the time for comparable transactions with persons not affiliated with HCC or HBC;

HBC must follow credit underwriting procedures at least as stringent as those applicable to comparable transactions with persons who are not affiliated with HCC or HBC; and

the loans must not involve a greater than normal risk of non-payment or include other features not favorable to HBC.

Furthermore, HBC must periodically report all loans made to directors and other insiders to the bank regulators, and these loans are closely scrutinized by the regulators for compliance with Sections 22(g) and 22(h) of the Federal Reserve Act and Regulation O. Each loan to directors or other insiders must be pre-approved by the HBC board of directors with the interested director abstaining from voting.

*Environmental Regulation.* Federal, state and local laws and regulations regarding the discharge of harmful materials into the environment may have an impact on HBC. Since HBC is not involved in any business that manufactures, uses or transports chemicals, waste, pollutants or toxins that might have a material adverse effect on the environment, HBC's primary exposure to environmental laws is through its lending activities and through properties or businesses HBC may own, lease or acquire. Based on a general survey of HBC's loan portfolio, conversations with local appraisers and the type of lending currently and historically done by HBC, management is not aware of any potential liability for hazardous waste contamination that would be reasonably likely to have a material adverse effect on the Company as of December 31, 2013.

*Safeguarding of Customer Information and Privacy.* The Federal Reserve and other bank regulatory agencies have adopted guidelines for safeguarding confidential, personal customer information. These guidelines require financial institutions to create, implement and maintain a comprehensive written information security program designed to ensure the security and confidentiality of customer information, protect against any anticipated threats or hazards to the security or integrity of such information and protect against unauthorized access to or use of such information that could result in substantial harm or inconvenience to any customer. HBC has adopted a customer information security program to comply with such requirements.

Financial institutions are also required to implement policies and procedures regarding the disclosure of nonpublic personal information about consumers to non-affiliated third parties. In general, financial institutions must provide explanations to consumers on policies and procedures regarding the disclosure of such nonpublic personal information, and, except as otherwise required by law, prohibits disclosing such information. HBC has implemented privacy policies addressing these restrictions which are distributed regularly to all existing and new customers of HBC.

*USA Patriot Act of 2001.* The USA Patriot Act of 2001 (the "Patriot Act") is intended to strengthen the ability of U.S. law enforcement agencies and intelligence communities to work cohesively to combat terrorism on a variety of fronts. The impact of the Patriot Act on financial institutions of all kinds has been significant and wide-ranging. The Patriot Act substantially enhanced existing anti-money laundering and financial transparency laws, and required appropriate regulatory authorities to adopt rules to promote

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cooperation among financial institutions, regulators, and law enforcement entities in identifying parties that may be involved in terrorism or money laundering. Under the Patriot Act, financial institutions are subject to prohibitions regarding specified financial transactions and account relationships, as well as enhanced due diligence and "know your customer" standards in their dealings with foreign financial institutions and foreign customers. For example, the enhanced due diligence policies, procedures, and controls generally require financial institutions to take reasonable steps:

to conduct enhanced scrutiny of account relationships to guard against money laundering and report any suspicious transactions;

to ascertain the identity of the nominal and beneficial owners of, and the source of funds deposited into, each account as needed to guard against money laundering and report any suspicious transactions;

to ascertain for any foreign bank, the shares of which are not publicly traded, the identity of the owners of the foreign bank, and the nature and extent of the ownership interest of each such owner; and

to ascertain whether any foreign bank provides correspondent accounts to other foreign banks and, if so, the identity of those foreign banks and related due diligence information.

The Patriot Act also requires all financial institutions to establish anti-money laundering programs, which must include, at a minimum:

the development of internal policies, procedures, and controls;

the designation of a compliance officer;

an ongoing employee training program; and

an independent audit function to test the programs.

Material deficiencies in anti-money laundering compliance can result in public enforcement actions by the banking agencies, including the imposition of civil money penalties and supervisory restrictions on growth and expansion. Such enforcement actions could also have serious reputation consequences for the Company.

*Office of Foreign Assets Control Regulation.* The United States has imposed economic sanctions that affect transactions with designated foreign countries, nationals and others. These are typically known as the "OFAC" rules based on their administration by the U.S. Treasury Department Office of Foreign Assets Control (the "OFAC"). The OFAC-administered sanctions targeting countries take many different forms. Generally, however, they contain one or more of the following elements: (i) restrictions on trade with or investment in a sanctioned country, including prohibitions against direct or indirect imports from and exports to a sanctioned country and prohibitions on "U.S. persons" engaging in financial transactions relating to making investments in, or providing investment related advice or assistance to, a sanctioned country; and (ii) a blocking of assets in which the government or specially designated nationals of the sanctioned country have an interest, by prohibiting transfers of property subject to U.S. jurisdiction (including property in the possession or control of U.S. persons). Blocked assets (e.g., property and bank deposits) cannot be paid out, withdrawn, set off or transferred in any manner without a license from the OFAC. Failure to comply with these sanctions could have serious legal and reputational consequences.

### ***Interstate Banking and Branching***

The Riegle Neal Interstate Banking and Branching Efficiency Act of 1994 (the "Interstate Banking Act") regulates the interstate activities of banks and bank holding companies and establishes a framework for nationwide interstate banking and branching. Since 1995, adequately capitalized and managed bank holding companies have been permitted to acquire banks located in any state, subject to two exceptions:



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first, any state may still prohibit bank holding companies from acquiring a bank which is less than five years old; and second, no interstate acquisition can be consummated by a bank holding company if the acquirer would control more than 10% of the deposits held by insured depository institutions nationwide or 30% or more of the deposits held by insured depository institutions in any state in which the target bank has branches. In 1995, California enacted legislation to implement important provisions of the Interstate Banking Act and to repeal California's previous interstate banking laws, which were largely preempted by the Interstate Banking Act. A bank may establish and operate de novo branches in any state in which the bank does not maintain a branch if that state has enacted legislation to expressly permit all out-of-state banks to establish branches in that state. However, California law expressly prohibits an out-of-state bank which does not already have a California branch office from (i) purchasing a branch office of a California bank (as opposed to purchasing the entire bank) and thereby establishing a California branch office, or (ii) establishing a de novo branch in California. It appears that the Interstate Banking Act and related California laws have contributed to the accelerated consolidation of the banking industry and increased competition, with many large out-of-state banks having entered the California market as a result of this legislation.

***Consumer Financial Protection and Other Consumer Laws and Regulations***

Dodd-Frank created the Consumer Financial Protection Bureau ("CFPB") as a new and independent unit within the Federal Reserve System. With certain exceptions, the CFPB has authority to regulate any person or entity that engages in offering or providing a "consumer financial product or service," and it has rulemaking, examination, and enforcement powers over financial institutions. With respect to primary examination and enforcement authority of financial entities, however, the CFPB's authority is limited to institutions with assets of \$10 billion or more. Existing regulators retain this authority over institutions with assets of \$10 billion or less, such as HBC.

The powers of the CFPB currently include:

the ability to prescribe consumer financial laws and rules that regulate all institutions that engage in offering or providing a consumer financial product or service;

primary enforcement and exclusive supervision authority over insured institutions with assets of \$10 billion or more with respect to federal consumer financial laws, including the right to obtain information about an institution's activities and compliance systems and procedures and to detect and assess risks to consumers and markets;

the ability to require reports from institutions with assets under \$10 billion to support the CFPB in implementing federal consumer financial laws, supporting examination activities, and assessing and detecting risks to consumers and financial markets; and

examination authority (limited to assessing compliance with federal consumer financial law) with respect to institutions with assets under \$10 billion, such as HBC, to the extent that a CFPB examiner may be included in the examinations performed by the institution's primary regulator.

The CFPB officially commenced operations on July 21, 2011 and has engaged in numerous activities since then, including: (i) investigating consumer complaints about credit cards and mortgages; (ii) launching a supervision program; (iii) conducting research for and developing mandatory financial product disclosures; and (iv) engaging in consumer financial protection rulemaking. The CFPB recently issued a final rule that requires creditors to make a reasonable good faith determination of a consumer's ability to repay any consumer credit transaction secured by a dwelling. The rule provides creditors with minimum requirements for making such ability-to-repay determinations. The full extent of the CFPB's authority and potential impact on HBC is unclear at this time, and HBC continues to monitor the CFPB's activities on an ongoing basis.



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HBC is already subject to a variety of statutes and regulations designed to protect consumers, including the Fair Credit Reporting Act, Equal Credit Opportunity Act, and Truth-in-Lending Act. Interest and other charges collected or contracted for by HBC are also subject to state usury laws and certain other federal laws concerning interest rates. HBC's loan operations are also subject to federal laws and regulations applicable to credit transactions. Together, these laws and regulations include provisions that:

govern disclosures of credit terms to borrowers who are consumers;

require financial institutions to provide information to enable the public and public officials to determine whether a financial institution is fulfilling its obligations in meeting the housing needs of the communities it serves;

prohibit discrimination on the basis of race, creed, or other prohibited factors in extending credit;

govern the use and provision of information to credit reporting agencies; and

govern the manner in which consumer debts may be collected by collection agencies.

HBC's deposit operations are also subject to laws and regulations that:

impose a duty to maintain the confidentiality of consumer financial records and prescribe procedures for complying with administrative subpoenas of financial records; and

govern automatic deposits to and withdrawals from deposit accounts and customers' rights and liabilities arising from the use of automated teller machines and other electronic banking services.

### ***Enforcement Authority***

The federal and California regulatory structure gives the bank regulatory agencies extensive discretion in connection with their supervisory and enforcement activities and examination policies, including policies with respect to the classification of assets and the establishment of adequate loan loss reserves for regulatory purposes. The regulatory agencies have adopted guidelines to assist in identifying and addressing potential safety and soundness concerns before an institution's capital becomes impaired. The guidelines establish operational and managerial standards generally relating to: (i) internal controls, information systems, and internal audit systems; (ii) loan documentation; (iii) credit underwriting; (iv) interest-rate exposure; (v) asset growth and asset quality; and (vi) compensation, fees, and benefits. Further, the regulatory agencies have adopted safety and soundness guidelines for asset quality and for evaluating and monitoring earnings to ensure that earnings are sufficient for the maintenance of adequate capital and reserves. If, as a result of an examination, the DFI or the Federal Reserve should determine that the financial condition, capital resources, asset quality, earnings prospects, management, liquidity, or other aspects of HBC's operations are unsatisfactory or that HBC or its management is violating or has violated any law or regulation, the DFI and the Federal Reserve, and separately the FDIC as insurer of the HBC's deposits, have residual authority to:

require affirmative action to correct any conditions resulting from any violation or practice;

direct an increase in capital and the maintenance of higher specific minimum capital ratios, which may preclude HBC from being deemed well capitalized and restrict its ability to accept certain brokered deposits;

restrict HBC's growth geographically, by products and services, or by mergers and acquisitions, including bidding in FDIC receiverships for failed banks;

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enter into or issue informal or formal enforcement actions, including required Board of Directors' resolutions, memoranda of understanding, written agreements and consent or cease and desist orders or prompt corrective action orders to take corrective action and cease unsafe and unsound practices;

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require prior approval of senior executive officer or director changes; remove officers and directors and assess civil monetary penalties; and

take possession of and close and liquidate HBC or appoint the FDIC as receiver.

***Deposit Insurance***

The FDIC is an independent federal agency that insures deposits, up to prescribed statutory limits, of federally insured banks and savings institutions and safeguards the safety and soundness of the banking and savings industries. The FDIC insures HBC's customer deposits through the Deposit Insurance Fund (the "DIF") up to prescribed limits for each depositor. Pursuant to Dodd-Frank, the maximum deposit insurance amount has been permanently increased to \$250,000. The amount of FDIC assessments paid by each DIF member institution is based on its relative risk of default as measured by regulatory capital ratios and other supervisory factors.

HBC is subject to deposit insurance assessments to maintain the DIF. The FDIC adopted a revised restoration plan to ensure that the DIF's designated reserve ratio ("DRR") reaches 1.35% of insured deposits by September 30, 2020, the deadline mandated by Dodd-Frank. However, financial institutions like HBC with assets of less than \$10 billion are exempted from the cost of this increase. The restoration plan proposed an increase in the DRR to 2% of estimated insured deposits as a long-term goal for the fund. The FDIC also proposed future assessment rate reductions in lieu of dividends, when the DRR reaches 1.5% or greater.

Furthermore, the FDIC redefined its deposit insurance premium assessment base from an institution's total domestic deposits to its total assets less tangible equity, effective in the second quarter of 2011. The changes to the assessment base necessitated changes to assessment rates, which also became effective April 1, 2011. The revised assessment rates are lower than prior rates, but the assessment base is larger and approximately the same amount of assessment revenue is being collected by the FDIC.

To help address liquidity issues created by potential timing differences between the collection of premiums and charges against the DIF, in November 2009 the FDIC adopted a final rule to require insured institutions to prepay, on December 31, 2009, estimated quarterly risk-based deposit insurance assessments for the fourth quarter of 2009, and for all of 2010, 2011 and 2012. HBC was exempt from the prepayment requirement by the FDIC.

In addition to DIF assessments, banks must pay quarterly assessments that are applied to the retirement of Financing Corporation ("FICO") bonds issued in the 1980's to assist in the recovery of the savings and loan industry. The FICO assessment amount fluctuates quarterly, but was 0.00155% of average total assets less average tangible equity for the third quarter of 2013. As of the date of this report, the Company had not received the FICO assessment for the fourth quarter of 2013. Those assessments will continue until the Financing Corporation bonds mature in 2019.

We are generally unable to control the amount of premiums that we are required to pay for FDIC insurance. If there are additional bank or financial institution failures or if the FDIC otherwise determines, we may be required to pay even higher FDIC premiums than the recently increased levels. These announced increases and any future increases in FDIC insurance premiums may have a material and adverse effect on our earnings and could have a material adverse effect on the value of, or market for, our common stock.

The FDIC may terminate a depository institution's deposit insurance upon a finding that the institution's financial condition is unsafe or unsound or that the institution has engaged in unsafe or unsound practices that pose a risk to the DIF or that may prejudice the interest of the bank's depositors. The termination of deposit insurance for a bank would also result in the revocation of the bank's charter by the DFI.

Table of Contents***Capital Adequacy Requirements***

HCC and HBC are subject to the regulations of the Federal Reserve Board and the FDIC, respectively, governing capital adequacy. Each of the federal regulators has established risk-based and leverage capital guidelines for the banks and/or bank holding companies it regulates, which set total capital requirements and define capital in terms of "core capital elements," or Tier 1 capital; and "supplemental capital elements," or Tier 2 capital. Tier 1 capital is generally defined as the sum of the core capital elements less goodwill and certain other deductions, including the unrealized net gains or losses (after tax adjustments) on available-for-sale investment securities, and disallowed deferred tax assets.

The following items are defined as core capital elements: (i) common shareholders' equity; (ii) qualifying non-cumulative perpetual preferred stock and related surplus (and, in the case of holding companies, senior perpetual preferred stock issued to the U.S. Treasury Department pursuant to the Troubled Asset Relief Program); (iii) minority interests in the equity accounts of consolidated subsidiaries; and (iv) "restricted" core capital elements (which include qualifying trust preferred securities) up to 25% of all core capital elements, net of goodwill less any associated deferred tax liability. Supplementary capital elements include: (i) allowance for loan and lease losses (but not more than 1.25% of an institution's risk-weighted assets); (ii) perpetual preferred stock and related surplus not qualifying as core capital; (iii) hybrid capital instruments, perpetual debt and mandatory convertible debt instruments; and, (iv) term subordinated debt and intermediate-term preferred stock and related surplus. The maximum amount of Tier 2 capital is capped at 100% of Tier 1 capital.

The minimum required ratio of qualifying total capital to total risk-weighted assets is 8% ("Total Risk-Based Capital Ratio"), and the minimum required ratio of Tier 1 capital to total risk-weighted assets is 4% ("Tier 1 Risk-Based Capital Ratio"). Risk-based capital ratios are calculated to provide a measure of capital relative to the degree of risk associated with a financial institution's operations for transactions reported on the balance sheet as assets, and transactions, such as letters of credit and recourse arrangements, which are recorded as off-balance sheet items. Under risk-based capital guidelines, the nominal dollar amounts of assets and credit-equivalent amounts of off-balance sheet items are multiplied by one of several risk adjustment percentages, which range from 0% for assets with low credit risk, such as cash on hand and certain U.S. Treasury securities, to 100% for assets with relatively high credit risk, such as unsecured loans. As of December 31, 2013 and 2012, HBC's Total Risk-Based Capital Ratios were 13.9% and 15.3% respectively, and HBC's Tier 1 Risk-Based Capital Ratios were 12.6% and 14.0%, respectively. As of December 31, 2013 and 2012, the consolidated Company's Total Risk-Based Capital Ratios were 15.3% and 16.2%, respectively, and its Tier 1 Risk-Based Capital Ratios were 14.0% and 15.0%, respectively.

The FDIC and the Federal Reserve Board have also established guidelines for a financial institution's leverage ratio, defined as Tier 1 capital to adjusted total assets. Banks and bank holding companies that have received the highest rating of the five categories used by regulators to rate banks and are not anticipating or experiencing any significant growth must maintain a leverage ratio of at least 3%. All other institutions are typically required to maintain a leverage ratio of at least 4% to 5%; however, federal regulations also provide that financial institutions must maintain capital levels commensurate with the level of risk to which they are exposed, including the volume and severity of problem loans, and federal regulators may set higher capital requirements when an institution's particular circumstances warrant. HBC's leverage ratios were 10.1% and 10.7% on December 31, 2013 and 2012, respectively. As of December 31, 2013 and 2012, the consolidated Company's leverage ratios were 11.2% and 11.5%, respectively.

Risk-based capital requirements also take into account concentrations of credit involving collateral or loan type, and the risks of "non-traditional" activities (those that have not customarily been part of the banking business). The regulations require institutions with high or inordinate levels of risk to operate with higher minimum capital standards, and authorize the regulators to review an institution's management of

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such risks in assessing an institution's capital adequacy. Additionally, the regulatory Statements of Policy on risk-based capital include exposure to interest rate risk as a factor that the regulators will consider in evaluating a financial institution's capital adequacy, although interest rate risk does not impact the calculation of an institution's risk-based capital ratios. Interest rate risk is the exposure of a bank's current and future earnings and equity capital to adverse movement in interest rates. While interest rate risk is inherent in a financial institution's role as a financial intermediary, it introduces volatility to the institution's earnings and economic value.

In July 2013, the Federal banking regulators approved a final rule to implement the revised capital adequacy standards of the Basel Committee on Banking Supervision, commonly called Basel III, and to address relevant provisions of Dodd-Frank. The final rule strengthens the definition of regulatory capital, increases risk-based capital requirements, makes selected changes to the calculation of risk-weighted assets, and adjusts the prompt corrective action thresholds. Community banking organizations, such as HCC and HBC, become subject to the new rule on January 1, 2015 and certain provisions of the new rule will be phased in over the period of 2015 through 2019. The final rule:

Requires a minimum ratio of common equity Tier 1 capital to risk-weighted assets of 4.5%.

Increases the minimum Tier 1 capital to risk-weighted assets ratio requirement from 4% to 6%.

Retains the minimum total capital to risk-weighted assets ratio requirement of 8%.

Establishes a minimum leverage ratio requirement of 4%.

Retains the existing regulatory capital framework for 1-4 family residential mortgage exposures.

Permits banking organizations that are not subject to the advanced approaches rule, such as HCC and HBC, to retain, through a one-time election, the existing treatment for most accumulated other comprehensive income, such that unrealized gains and losses on securities available for sale will not affect regulatory capital amounts and ratios.

Implements a new capital conservation buffer requirement for a banking organization to maintain a common equity capital ratio more than 2.5% above the minimum common equity Tier 1 capital, Tier 1 capital and total risk-based capital ratios in order to avoid limitations on capital distributions, including dividend payments, and certain discretionary bonus payments. The capital conservation buffer requirement will be phased in beginning on January 1, 2016 at 0.625% and will be fully phased in at 2.50% by January 1, 2019. A banking organization with a buffer of less than the required amount would be subject to increasingly stringent limitations on such distributions and payments as the buffer approaches zero. The new rule also generally prohibits a banking organization from making such distributions or payments during any quarter if its eligible retained income is negative and its capital conservation buffer ratio was 2.5% or less at the end of the previous quarter. The eligible retained income of a banking organization is defined as its net income for the four calendar quarters preceding the current calendar quarter, based on the organization's quarterly regulatory reports, net of any distributions and associated tax effects not already reflected in net income.

Increases capital requirements for past-due loans, high volatility commercial real estate exposures, and certain short-term commitments and securitization exposures.

Expands the recognition of collateral and guarantors in determining risk-weighted assets.

Removes references to credit ratings consistent with Dodd-Frank and establishes due diligence requirements for securitization exposures.

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Permits banking organizations that had less than \$15 billion in total consolidated assets as of December 31, 2009, or were mutual holding companies as of May 19, 2010, to include in Tier 1 capital trust preferred securities and cumulative perpetual preferred stock that were issued and

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included in Tier 1 capital prior to May 19, 2010, subject to a limit of 25% of Tier 1 capital elements, excluding any non-qualifying capital instruments and after all regulatory capital deductions and adjustments have been applied to Tier 1 capital.

Establishes new qualifying criteria for regulatory capital, including new limitations on the inclusion of deferred tax assets and mortgage servicing rights.

Potential changes that could materially affect us include the additional constraints on the inclusion of deferred tax assets in capital, increased risk weightings for nonperforming loans and acquisition/development loans, and the inclusion of accumulated other comprehensive income in regulatory capital. The inclusion of Accumulated Other Comprehensive Income ("AOCI") would benefit us as long as we have a net unrealized gain on securities, but would lower our regulatory capital ratios if interest rates increase and our unrealized gain becomes an unrealized loss. However, under the new regulations the Company can make a one-time opt out to exclude AOCI.

The aggregate effect of these regulatory changes on HCC and HBC cannot yet be determined with any degree of certainty, but our preliminary estimates indicate that if the changes are implemented and when they become fully phased-in they will not have a material impact on our Tier 1 Leverage Ratio and our consolidated Tier 1 Risk-Based Capital Ratio. Given our current level of capital we should be well-positioned to absorb the impact of Basel III without constraining our organic growth plans, although no assurance can be provided in that regard. For more information on the Company's capital, see *"Part II, Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operation - Capital Resources."*

***Prompt Corrective Action Provisions***

Federal law requires each banking agency to take "prompt corrective action" with respect to a depository institution if that institution does not meet certain capital adequacy standards, including requiring the prompt submission of an acceptable capital restoration plan. Supervisory actions by the appropriate federal banking regulator under the prompt corrective action rules generally depend upon an institution's classification within five capital categories as defined in the regulations. The relevant capital measures are the capital ratio, the Tier 1 capital ratio, and the leverage ratio.

The federal banking agencies have also adopted non-capital safety and soundness standards to assist examiners in identifying and addressing potential safety and soundness concerns before capital becomes impaired. These include: operational and managerial standards relating to: (i) internal controls, information systems and internal audit systems; (ii) loan documentation; (iii) credit underwriting; (iv) asset quality and growth; (v) earnings; (vi) risk management; and (vii) compensation and benefits.

A depository institution's category of compliance under the prompt corrective action regulations will depend upon how its capital levels compare with various relevant capital measures and the other factors established by the regulations. A bank will be:

"well capitalized" if the institution has a total risk-based capital ratio of 10.0% or greater, a Tier 1 risk-based capital ratio of 6.0% or greater, and a leverage ratio of 5.0% or greater, and is not subject to any order or written directive by any such regulatory authority to meet and maintain a specific capital level for any capital measure;

"adequately capitalized" if the institution has a total risk-based capital ratio of 8.0% or greater, a Tier 1 risk-based capital ratio of 4.0% or greater, and a leverage ratio of 4.0% or greater (or 3% if the institution receives the highest rating from its primary regulator) and is not "well capitalized";

"undercapitalized" if the institution has a total risk-based capital ratio that is less than 8.0%, a Tier 1 risk-based capital ratio of less than 4.0%, or a leverage ratio of less than 4.0% (or 3% if the institution receives the highest rating from its primary regulator);

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"significantly undercapitalized" if the institution has a total risk-based capital ratio of less than 6.0%, a Tier 1 risk-based capital ratio of less than 3.0%, or a leverage ratio of less than 3.0%; and

"critically undercapitalized" if the institution's tangible equity is equal to or less than 2.0% of average quarterly tangible assets.

The appropriate federal banking agency may, under certain circumstances, reclassify a well-capitalized insured depository institution as adequately capitalized. An institution may be reclassified if the appropriate federal banking agency determines (after notice and opportunity for a hearing) that the institution is in an unsafe or unsound condition or deems the institution to be engaging in an unsafe or unsound practice. The appropriate agency is also permitted to require an adequately capitalized or undercapitalized institution to comply with the supervisory provisions as if the institution were in the next lower category (but not treat a significantly undercapitalized institution as critically undercapitalized) based on supervisory information other than the capital levels of the institution.

At each successively lower capital category, an insured bank is subject to increased restrictions on its operations. For example, a bank is generally prohibited from paying management fees to any controlling persons or from making capital distributions if to do so would make the bank "undercapitalized." Asset growth and branching restrictions apply to undercapitalized banks, which are required to submit written capital restoration plans meeting specified requirements (including a guarantee by the parent holding company, if any). "Significantly undercapitalized" banks are subject to broad regulatory authority, including among other things, capital directives, forced mergers, restrictions on the rates of interest they may pay on deposits, restrictions on asset growth and activities, and prohibitions on paying bonuses or increasing compensation to senior executive officers without FDIC approval. Even more severe restrictions apply to "critically undercapitalized" banks. Most importantly, except under limited circumstances, not later than 90 days after an insured bank becomes critically undercapitalized the appropriate federal banking agency is required to appoint a conservator or receiver for the bank.

***Dividends***

It is the Federal Reserve's policy that bank holding companies should generally pay dividends on common stock only out of income available over the past year, and only if prospective earnings retention is consistent with the organization's expected future needs and financial condition. It is also the Federal Reserve's policy that bank holding companies should not maintain dividend levels that undermine their ability to be a source of strength to its banking subsidiaries. Additionally, in consideration of the current financial and economic environment, the Federal Reserve has indicated that bank holding companies should carefully review their dividend policy and has discouraged payment ratios that are at maximum allowable levels unless both asset quality and capital are very strong.

HBC is a legal entity that is separate and distinct from its holding company. HCC receives cash through dividends paid by HBC. Subject to the regulatory restrictions which currently further restrict the ability of HBC to declare and pay dividends, future cash dividends by HBC will depend upon management's assessment of future capital requirements, contractual restrictions, and other factors.

The ability of the Board of Directors of HBC to declare a cash dividend to HCC is subject to California law, which restricts the amount available for cash dividends to the lesser of a bank's retained earnings or net income for its last three fiscal years (less any distributions to shareholders made during such period). Where this test is not met, cash dividends may still be paid, with the prior approval of the DFI in an amount not exceeding the greatest of (i) retained earnings of the bank; (ii) the net income of the bank for its last fiscal year; or (iii) the net income of the bank for its current fiscal year. A California bank may also with the prior approval of the DFI and approval of the bank's shareholders distribute a dividend in connection with a reduction of capital of the bank. If the DFI determines that the shareholders' equity of the bank paying the dividend is not adequate or that the payment of the dividend would be unsafe or unsound for the bank, the DFI may order the bank not to pay the dividend. Since HBC is an FDIC-insured



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institution, it is also possible, depending upon its financial condition and other factors, that the FDIC could assert that the payment of dividends or other payments might, under some circumstances, constitute an unsafe or unsound practice and thereby prohibit such payments.

The California General Corporation Law prohibits HCC from making distributions, including dividends, to holders of its common stock or preferred stock unless either of the following tests are satisfied: (i) the amount of retained earnings immediately prior to the distribution equals or exceeds the sum of (A) the amount of the proposed distribution plus (B) any cumulative dividends in arrears on all shares having a preference with respect to the payment of dividends over the class or series to which the applicable distribution is being made; or (ii) immediately after the distribution, the value of HCC's consolidated assets would equal or exceed the sum of its total liabilities, plus the amounts that would be payable to satisfy the preferential rights of other shareholders upon a dissolution that are superior to the rights of the shareholders receiving the distribution.

***Federal Banking Agency Compensation Guidelines***

Guidelines adopted by the federal banking agencies prohibit excessive compensation as an unsafe and unsound practice and describe compensation as excessive when the amounts paid are unreasonable or disproportionate to the services performed by an executive officer, employee, director or principal stockholder. In June 2010, the federal bank regulatory agencies jointly issued additional comprehensive guidance on incentive compensation policies (the "Incentive Compensation Guidance") intended to ensure that the incentive compensation policies of banking organizations do not undermine the safety and soundness of such organizations by encouraging excessive risk-taking. The Incentive Compensation Guidance, which covers all employees that have the ability to materially affect the risk profile of an organization, either individually or as part of a group, is based upon the key principles that a banking organization's incentive compensation arrangements should: (i) provide incentives that do not encourage risk-taking beyond the organization's ability to effectively identify and manage risks; (ii) be compatible with effective internal controls and risk management; and (iii) be supported by strong corporate governance, including active and effective oversight by the organization's board of directors. Any deficiencies in compensation practices that are identified may be incorporated into the organization's supervisory ratings, which can affect its ability to make acquisitions or perform other actions. The Incentive Compensation Guidance provides that enforcement actions may be taken against a banking organization if its incentive compensation arrangements or related risk-management control or governance processes pose a risk to the organization's safety and soundness and the organization is not taking prompt and effective measures to correct the deficiencies.

On February 7, 2011, the Board of Directors of the FDIC approved a joint proposed rule to implement Section 956 of Dodd-Frank for banks with \$1 billion or more in assets. Section 956 prohibits incentive-based compensation arrangements that encourage inappropriate risk taking by covered financial institutions and are deemed to be excessive, or that may lead to material losses. The proposed rule would move the U.S. closer to aspects of international compensation standards by: (i) requiring deferral of a substantial portion of incentive compensation for executive officers of particularly large institutions described above; (ii) prohibiting incentive-based compensation arrangements for covered persons that would encourage inappropriate risks by providing excessive compensation; (iii) prohibiting incentive-based compensation arrangements for covered persons that would expose the institution to inappropriate risks by providing compensation that could lead to a material financial loss; (iv) requiring policies and procedures for incentive-based compensation arrangements that are commensurate the size and complexity of the institution; and (v) requiring annual reports on incentive compensation structures to the institution's appropriate Federal regulator.

The scope, content and application of the U.S. banking regulators' policies on incentive compensation continue to evolve. It cannot be determined at this time whether compliance with such policies will adversely affect the ability of the Company to hire, retain and motivate key employees.

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*Allowance for Loan and Lease Losses*

In December 2006, the federal bank regulatory agencies released an Interagency Policy Statement on the Allowance for Loan and Lease Losses ("ALLL"), which revises and replaces the banking agencies' 1993 policy statement on the ALLL. The revised statement was issued to ensure consistency with generally accepted accounting principles ("GAAP") and more recent supervisory guidance, and it extended the scope to include credit unions. Highlights of the revised statement include the following:

the revised statement emphasizes that the ALLL represents one of the most significant estimates in an institution's financial statements and regulatory reports, and that an assessment of the appropriateness of the ALLL is critical to an institution's safety and soundness;

each institution has a responsibility to develop, maintain, and document a comprehensive, systematic, and consistently applied process for determining the amounts of the ALLL;

each institution must maintain an ALLL that is sufficient to cover estimated credit losses on individual impaired loans as well as estimated credit losses inherent in the remainder of the portfolio; and

the revised statement clarifies previous guidance on the ALLL with regard to: (i) responsibilities of the board of directors, management, and bank examiners; (ii) factors to be considered in the estimation of ALLL; and (iii) objectives and elements of an effective loan review system.

In December 2012, the FASB issued a proposed accounting standards update on "Financial Instruments - Credit Losses" with the goal of eliminating the overstatement of assets caused by a delayed recognition of credit losses associated with loans (and other financial instruments). The comment period on the proposal ended on May 31, 2013, but no effective date for the guidance has been suggested. If ultimately implemented as proposed, the guidance would require us to modify the methodology we use to determine our allowance for loan and lease losses from the current "incurred loss" model to a new "expected credit loss" model that considers more forward-looking information. That change could potentially necessitate a significant increase in our allowance for loan and lease losses, which could negatively impact our profitability if our loan loss provision needs to be increased accordingly.

*Other Pending and Proposed Legislation*

Other legislative and regulatory initiatives which could affect HCC, HBC and the banking industry in general may be proposed or introduced before the United States Congress, the California legislature and other governmental bodies in the future. Such proposals, if enacted, may further alter the structure, regulation and competitive relationship among financial institutions, and may subject HCC or HBC to increased regulation, disclosure and reporting requirements. In addition, the various banking regulatory agencies often adopt new rules and regulations to implement and enforce existing legislation. It cannot be predicted whether, or in what form, any such legislation or regulations may be enacted or the extent to which the business of HCC or HBC would be affected thereby.

**Employees**

At December 31, 2013, the Company had 193 full-time equivalent employees. The Company's employees are not represented by any union or collective bargaining agreement and the Company believes its employee relations are satisfactory.

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**ITEM 1A RISK FACTORS**

*Our business, financial condition and results of operations are subject to various risks, including those discussed below. The risks discussed below are those that we believe are the most significant risks, although additional risks not presently known to us or that we currently deem less significant may also adversely affect our business, financial condition and results of operations, perhaps materially.*

**Risks Relating to Recent Economic Conditions and Governmental Response Efforts**

*Our business may be adversely affected by business and economic conditions.*

We are operating in an uncertain economic environment. While there are signs of economic conditions improving, the persistent high unemployment rate, weak business and consumer spending, the U.S. budget deficit and uncertainty in European economies underline that the economy remains uncertain. Business activity across a wide range of industries and regions is greatly affected. Local and state governments are in difficulty due to the reduction in sales taxes resulting from the lack of consumer spending and property taxes resulting from declining property values. Financial institutions continue to be affected by long-term high unemployment and underemployment rates and a stricter regulatory environment. While our market areas have not experienced the same degree of challenge in unemployment as other areas, the effects of these issues have trickled down to households and businesses in our markets. There can be no assurance that the recent economic improvement is sustainable and credit worthiness of our borrowers will not deteriorate. Continual economic uncertainty and slow growth could adversely affect or financial condition and results of operations, including a decline in demand for loans and other products and services, a decline in low cost or noninterest bearing deposits, a decline in the value of the collateral for our real estate loans, and an increase in loan delinquencies, nonperforming assets, and net charge-offs. If our deposit growth level outpaces our loan growth, we could as a result have excess liquidity earning a less favorable yield. As the economy is uncertain, businesses are wary about capital expenditures or expansion of working capital.

*Government responses to economic conditions may adversely affect our operations, financial condition and earnings.*

The Dodd-Frank Act of 2010 ("Dodd-Frank") has changed the bank regulatory framework with the creation of an independent Consumer Financial Protection Bureau that has assumed the consumer protection responsibilities of the various federal banking agencies, and has resulted in more stringent capital standards for banks and bank holding companies. The legislation requires additional regulations affecting the lending, funding, trading and investment activities of banks and bank holding companies. Bank regulatory agencies also have been responding aggressively to concerns and adverse trends identified in examinations. Ongoing uncertainty and adverse developments in the financial services industry and the domestic and international credit markets, and the effect of new legislation and regulatory actions in response to these conditions, may adversely affect our operations by restricting our business operations, including our ability to originate or sell loans, modify loan terms, or foreclose on property securing loans. These events may have a significant adverse effect on our financial performance and operating flexibility. In addition, these factors could affect the performance and value of our loan and investment securities portfolios, which also would negatively affect our financial performance.

Furthermore, the Board of Governors of the Federal Reserve System, in an attempt to help the overall economy, has, among other things, kept interest rates low through its targeted Federal funds rate and the purchase of mortgage-backed securities. If the Federal Reserve increases the Federal funds rate, overall interest rates will likely rise, which may negatively impact the housing markets and the U.S. economic recovery. In addition, deflationary pressures, while possibly lowering our operating costs, could have a significant negative effect on our borrowers, especially our business borrowers, and the values of underlying collateral securing loans, which could negatively affect our financial performance.

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***We will become subject to more stringent capital requirements.***

Dodd-Frank requires the federal banking agencies to establish minimum leverage and risk-based capital requirements for insured banks and their holding companies. The federal banking agencies issued a joint final rule, or the "Final Capital Rule," that implements the Basel III capital standards and establishes the minimum capital levels required under Dodd-Frank. We must comply with the Final Capital Rule by January 1, 2015. The Final Capital Rule establishes a minimum common equity Tier I capital ratio of 6.5% of risk-weighted assets for a "well-capitalized" institution and increases the minimum Tier I capital ratio for a "well-capitalized" institution from 6.0% to 8.0%. Additionally, the Final Capital Rule requires an institution to maintain a 2.5% common equity Tier I capital conservation buffer over the 6.5% minimum risk-based capital requirement to avoid restrictions on the ability to pay dividends, discretionary bonuses, and engage in share repurchases. The Final Capital Rule permanently grandfathered trust preferred securities issued before May 19, 2010, subject to a limit of 25% of Tier I capital. The Final Capital Rule increases the required capital for certain categories of assets, including high-volatility construction real estate loans and certain exposures related to securitizations; however, the Final Capital Rule retains the current capital treatment of residential mortgages. Under the Final Capital Rule, we may make a one-time, permanent election to continue to exclude accumulated other comprehensive income from capital. If we do not make this election, unrealized gains and losses will be included in the calculation of our regulatory capital. Implementation of these standards, or any other new regulations, may adversely affect our ability to pay dividends, or require us to reduce business levels or raise capital, including in ways that may adversely affect our results of operations or financial condition.

***Additional requirements imposed by the Dodd-Frank Act could adversely affect us.***

Current and future legal and regulatory requirements, restrictions, and regulations, including those imposed under the Dodd-Frank, may adversely impact our profitability and may have a material and adverse effect on our business, financial condition, and results of operations, may require us to invest significant management attention and resources to evaluate and make any changes required by the legislation and related regulations and may make it more difficult for us to attract and retain qualified executive officers and employees. Dodd-Frank comprehensively reformed the regulation of financial institutions, products and services. Because many aspects of the Dodd-Frank are subject to rulemaking and will take effect over several years, it is difficult to forecast the impact that such rulemaking will have on us, our customers or the financial industry. Certain provisions of Dodd-Frank that affect deposit insurance assessments, the payment of interest on demand deposits and interchange fees could increase the costs associated with our banking subsidiaries' deposit-generating activities, as well as place limitations on the revenues that those deposits may generate. In addition, Dodd-Frank established the Consumer Financial Protecting Bureau ("CFPB"). The CFPB has the authority to prescribe rules for all depository institutions governing the provision of consumer financial products and services, which may result in rules and regulations that reduce the profitability of such products and services or impose greater costs on the Company and its subsidiaries. Dodd-Frank also established new minimum mortgage underwriting standards for residential mortgages, and the regulatory agencies have focused on the examination and supervision of mortgage lending and servicing activities. The CFPB recently issued a final rule that requires creditors to make a reasonable good faith determination of a consumer's ability to repay any consumer credit transaction secured by a dwelling. The rule provides creditors with minimum requirements for making such ability-to-repay determinations.

**Risks Related to Our Market and Business**

***We are subject to credit risk.***

There are inherent risks associated with our lending activities. These risks include, among other things, the impact of changes in interest rates and changes in the economic conditions in the markets where we operate as well as those across the United States and abroad. Increases in interest rates and/or

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weakening economic conditions could adversely impact the ability of borrowers to repay outstanding loans or the value of the collateral securing these loans. We are also subject to various laws and regulations that affect our lending activities. Failure to comply with applicable laws and regulations could subject us to regulatory enforcement action that could result in the assessment of significant civil money penalties against us.

We seek to mitigate the risks inherent in our loan portfolio by adhering to specific underwriting practices. Although we believe that our underwriting criteria are appropriate for the various kinds of loans we make, we may incur losses on loans that meet our underwriting criteria, and these losses may exceed the amounts set aside as reserves in our allowance for loan losses. The value of real estate collateral supporting many construction and land development loans, land loans, commercial loans and multi-family loans may decline. Negative developments in the financial industry and credit markets may adversely impact our financial condition and results of operations.

***Our interest expense could increase following the repeal of the federal prohibition on payment of interest on demand deposits.***

The federal prohibition on the ability of financial institutions to pay interest on demand deposit accounts was repealed as part of Dodd-Frank. Financial institutions may commence offering interest on demand deposits to compete for customers. Our interest expense will increase and our net interest margin will decrease if HBC begins offering interest on demand deposits to attract additional customers or maintain current customers, which could have a material adverse effect on our financial condition, net income and results of operations.

***Our allowance for loan losses may not be adequate to cover actual loan losses, which could adversely affect our earnings.***

We maintain an allowance for loan losses for probable incurred losses in the portfolio. The allowance is established through a provision for loan losses based on management's evaluation of the risks inherent in the loan portfolio and the general economy. The allowance is also appropriately increased for new loan growth. The allowance is based upon a number of factors, including the size of the loan portfolio, asset classifications, economic trends, industry experience and trends, industry and geographic concentrations, estimated collateral values, management's assessment of the credit risk inherent in the portfolio, historical loan loss experience and loan underwriting policies. The allowance is only an estimate of the inherent loss in the loan portfolio and may not represent actual losses realized over time, either of losses in excess of the allowance or of losses less than the allowance.

In addition, we evaluate all loans identified as impaired loans and allocate an allowance based upon our estimation of the potential loss associated with those problem loans. While we strive to carefully manage and monitor credit quality and to identify loans that may be deteriorating, at any time there are loans included in the portfolio that may result in losses, but that have not yet been identified as non-performing or potential problem loans. Through established credit practices, we attempt to identify deteriorating loans and adjust the allowance for loan losses accordingly. However, because future events are uncertain and because we may not successfully identify all deteriorating loans in a timely manner, there may be loans that deteriorate in an accelerated time frame. We cannot be sure that we will be able to identify deteriorating loans before they become nonperforming assets, or that we will be able to limit losses on those loans that have been so identified. Changes in economic, operating and other conditions which are beyond our control, including interest rate fluctuations, deteriorating values in underlying collateral (most of which consists of real estate), and changes in the financial condition of borrowers, may cause our estimate of probable losses or actual loan losses to exceed our current allowance. As a result, future additions to the allowance may be necessary. Further, because the loan portfolio contains a number of commercial real estate, construction, and land development loans with relatively large balances, a deterioration in the credit quality of one or more of these loans may require a significant increase to the

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allowance for loan losses. Our regulators, as an integral part of their examination process, periodically review our allowance for loan losses and may require us to increase our allowance for loan losses by recognizing additional provisions for loan losses charged to expense, or to decrease our allowance for loan losses by recognizing loan charge-offs, net of recoveries. Any such additional provisions for loan losses or charge-offs, as required by these regulatory agencies, could have a material adverse effect on our financial condition and results of operations.

***Nonperforming assets take significant time to resolve and adversely affect our results of operations and financial condition.***

At December 31, 2013, nonperforming loans were 1.29% of the total loan portfolio and 0.83% of total assets. Nonperforming assets adversely affect our earnings in various ways. We do not record interest income on nonaccrual loans or other real estate owned, thereby adversely affecting our income, and increasing our loan administration costs. Upon foreclosure or similar proceedings, we record the repossessed asset at the estimated fair value, less costs to sell, which may result in a write down or losses. An increase in the level of nonperforming assets increases our risk profile and may impact the capital levels our regulators believe are appropriate in light of the increased risk profile. While we reduce problem assets through collection efforts, asset sales, workouts, restructurings and otherwise, decreases in the value of the underlying collateral, or in these borrowers' performance or financial condition, whether or not due to economic and market conditions beyond our control, could adversely affect our business, results of operations and financial condition. In addition, the resolution of nonperforming assets requires significant commitments of time from management and our directors, which can be detrimental to the performance of their other responsibilities.

***We may be required to make additional provisions for loan losses and charge off additional loans in the future, which could adversely affect our results of operations.***

For the year ended December 31, 2013, we recorded an \$816,000 credit to the provision for loan losses, charged-off \$2.0 million of loans, and recovered \$2.9 million of loans. Since 2008, there was a significant slowdown in the real estate markets in portions of counties in California where a majority of our loan customers, including our largest borrowing relationships, are based. This slowdown reflected declining prices in real estate, higher levels of inventories of homes and higher vacancies in commercial and industrial properties, all of which contributed to financial strain on real estate developers and suppliers. However, there was some improvement in 2013, with real estate prices beginning to increase in our market area. At December 31, 2013, we had \$423.3 million in commercial and residential real estate loans and \$31.4 million in land and construction real estate loans, of which \$4.4 million and \$1.8 million, respectively, were on nonaccrual. Construction loans and commercial real estate loans comprise a substantial portion of our nonperforming assets. Deterioration in the real estate market could affect the ability of our loan customers to service their debt, which could result in additional loan charge-offs and provisions for loan losses in the future, which could have a material adverse effect on our financial condition, results of operations and capital.

***Our business is subject to interest rate risk and variations in interest rates may negatively affect our financial performance.***

Our earnings and cash flows are highly dependent upon net interest income. Net interest income is the difference between interest income earned on interest earning assets such as loans and securities and interest expense paid on interest-bearing liabilities such as deposits and borrowed funds.

Interest rates are sensitive to many factors outside our control, including general economic conditions and policies of various governmental and regulatory agencies and, in particular, the Federal Reserve, which regulates the supply of money and credit in the United States. Changes in monetary policy, including changes in interest rates, could influence not only the interest we receive on loans and securities and

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interest we pay on deposits and borrowings, but could also affect our ability to originate loans and obtain deposits, and the fair value of our financial assets and liabilities. Our portfolio of securities is subject to interest rate risk and will generally decline in value if market interest rates increase, and generally increase in value if market interest rates decline.

In response to the recessionary state of the national economy, the housing market and the volatility of financial markets, the Federal Open Market Committee of the Federal Reserve ("FOMC") started a series of decreases in Federal funds target rate with seven decreases in 2008, bringing the target rate to a historically low range of 0% to 0.25% through December 2013.

Changes in interest rates and monetary policy can impact the demand for new loans, the credit profile of our borrowers, the yields earned on loans and securities and rates paid on deposits and borrowings. Given our current volume and mix of interest bearing liabilities and interest earning assets, we would expect our interest rate spread (the difference in the rates paid on interest bearing liabilities and the yields earned on interest earning assets) as well as net interest income to increase if interest rates rise and, conversely, to decline if interest rates fall. Additionally, increasing levels of competition in the banking and financial services business may decrease our net interest spread as well as net interest margin by forcing us to offer lower lending interest rates and pay higher deposit interest rates. Although we believe our current level of interest rate sensitivity is reasonable, significant fluctuations in interest rates (such as a sudden and substantial increase in Prime and Overnight Fed Funds rates) as well as increasing competition may require us to increase rates on deposits at a faster pace than the yield we receive on interest earning assets increases. The impact of any sudden and substantial move in interest rates and/or increased competition may have an adverse effect on our business, financial condition and results of operations, as our net interest income (including the net interest spread and margin) may be negatively impacted.

Additionally, a sustained decrease in market interest rates could adversely affect our earnings. When interest rates decline, borrowers tend to refinance higher-rate, fixed-rate loans at lower rates, prepaying their existing loans. Under those circumstances, we would not be able to reinvest those prepayments in assets earning interest rates as high as the rates on the prepaid loans. In addition, our commercial real estate and commercial loans, which carry interest rates that, in general, adjust in accordance with changes in the prime rate, will adjust to lower rates. We are also significantly affected by the level of loan demand available in our market. The inability to make sufficient loans directly affects the interest income we earn. Lower loan demand will generally result in lower interest income realized as we place funds in lower yielding investments.

***Our expenses could increase as a result of increases in FDIC insurance premiums.***

The FDIC, absent extraordinary circumstances, must establish and implement a plan to restore the deposit insurance reserve ratio to 1.35% of estimated insured deposits or the comparable percentage of the assessment base at any time the reserve ratio falls below that level. Bank failures during the current economic cycle depleted the deposit insurance fund balance, which was in a negative position from the end of 2009 through the first quarter of 2011. The FDIC currently has until September 30, 2020 to bring the reserve ratio back to the statutory minimum. As noted above under "Regulation and Supervision - Deposit Insurance", the FDIC has implemented a restoration plan that adopted a new assessment base and established new assessment rates starting with the second quarter of 2011. The FDIC also imposed a special assessment in 2009, and required the prepayment of three years of estimated FDIC insurance premiums at the end of 2009. The Company was exempted from the prepayment obligation. It is generally expected that assessment rates will remain relatively high in the near term due to the significant cost of bank failures and the relatively large number of troubled banks. Any further premium increases or special assessments could have a material adverse effect on our financial condition and results of operations.

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***Liquidity risk could impair our ability to fund operations and jeopardize our financial condition.***

Liquidity is essential to our business. An inability to raise funds through deposits, borrowings, the sale of loans and other sources could have a substantial negative effect on our liquidity. Our access to funding sources in amounts adequate to finance our activities could be impaired by factors that affect us specifically or the financial services industry in general. Factors that could detrimentally impact our access to liquidity sources include a decrease in the level of our business activity due to a market downturn in markets in which our loans are concentrated or adverse regulatory action against us. Our ability to borrow could also be impaired by factors that are not specific to us, such as a severe disruption of the financial markets or negative views and expectations about the prospects for the financial services industry as a whole.

***If we lost a significant portion of our low-cost deposits, it would negatively impact our liquidity and profitability.***

Our profitability depends in part on our success in attracting and retaining a stable base of low-cost deposits. At December 31, 2013, 34% of our deposit base was comprised of noninterest bearing deposits. While we generally do not believe these core deposits are sensitive to interest rate fluctuations, the competition for these deposits in our markets is strong and customers are increasingly seeking investments that are safe, including the purchase of U.S. Treasury securities and other government guaranteed obligations, as well as the establishment of accounts at the largest, most-well capitalized banks. If we were to lose a significant portion of our low-cost deposits, it would negatively impact our liquidity and profitability.

***We borrow from the Federal Home Loan Bank and the Federal Reserve, and there can be no assurance these programs will continue in their current manner.***

We, at times, utilize the Federal Home Loan Bank of San Francisco for overnight borrowings and term advances; we also borrow from the Federal Reserve Bank of San Francisco and from correspondent banks under our Federal funds lines of credit. The amount loaned to us is generally dependent on the value of the collateral pledged. These lenders could reduce the percentages loaned against various collateral categories, could eliminate certain types of collateral and could otherwise modify or even terminate their loan programs, particularly to the extent they are required to do so because of capital adequacy or other balance sheet concerns. Any change or termination of the programs under which we borrow from the Federal Home Loan Bank of San Francisco, the Federal Reserve Bank of San Francisco or correspondent banks could have an adverse effect on our liquidity and profitability.

***Our results of operations may be adversely affected by other-than-temporary impairment charges relating to our securities portfolio.***

We may be required to record future impairment charges on our securities, including our stock in the Federal Home Loan Bank of San Francisco, if they suffer declines in value that we consider other-than-temporary. Numerous factors, including the lack of liquidity for re-sales of certain securities, the absence of reliable pricing information for securities, adverse changes in the business climate, adverse regulatory actions or unanticipated changes in the competitive environment, could have a negative effect on our securities portfolio in future periods. Significant impairment charges could also negatively impact our regulatory capital ratios and result in HBC not being classified as "well-capitalized" for regulatory purposes.

***We depend on cash dividends from our subsidiary bank to pay cash dividends to our shareholders and to meet our cash obligations.***

As a holding company, dividends from our subsidiary bank provide a substantial portion of our cash flow used to pay cash dividends on our common and preferred stock and other obligations. Various statutory provisions restrict the amount of dividends HBC can pay to HCC without regulatory approval. See "Item 1 Business-Supervision and Regulation Dividends."



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***We may need to raise additional capital in the future and such capital may not be available when needed or at all.***

We may need to raise additional capital in the future to provide us with sufficient capital resources and liquidity to meet our commitments and business needs. Our ability to raise additional capital, if needed, will depend on, among other things, conditions in the capital markets at that time, which are outside of our control, and our financial performance. We cannot be assured that such capital will be available to us on acceptable terms or at all. Any occurrence that may limit our access to the capital markets, such as a decline in the confidence of debt purchasers, depositors of HBC or counterparties participating in the capital markets may adversely affect our capital costs and our ability to raise capital and, in turn, our liquidity. An inability to raise additional capital on acceptable terms when needed could have a material adverse effect on our business, financial condition and results of operations.

***Our profitability is dependent upon the economic conditions of the markets in which we operate.***

We operate primarily in Santa Clara County, Contra Costa County and Alameda County and, as a result, our financial condition and results of operations are subject to changes in the economic conditions in those areas. Our success depends upon the business activity, population, income levels, deposits and real estate activity in these markets. Although our customers' business and financial interests may extend well beyond these market areas, adverse economic conditions that affect these market areas could reduce our growth rate, affect the ability of our customers to repay their loans to us and generally affect our financial condition and results of operations. Our lending operations are located in market areas dependent on technology and real estate industries and their supporting companies. Thus, our borrowers could be adversely impacted by a downturn in these sectors of the economy that could reduce the demand for loans and adversely impact the borrowers' ability to repay their loans, which would, in turn, increase our nonperforming assets. Because of our geographic concentration, we are less able than regional or national financial institutions to diversify our credit risks across multiple markets.

***Our loan portfolio has a large concentration of real estate loans in California, which involve risks specific to real estate values.***

A downturn in our real estate markets in California could adversely affect our business because many of our loans are secured by real estate. Real estate lending (including commercial, land development and construction) is a large portion of our loan portfolio. At December 31, 2013, approximately \$506.5 million, or 55% of our loan portfolio, was secured by various forms of real estate, including residential and commercial real estate. Included in the \$506.5 million of loans secured by real estate were \$259.0 million (or 51%) of owner-occupied loans. The real estate securing our loan portfolio is concentrated in California. The market value of real estate can fluctuate significantly in a short period of time as a result of market conditions in the geographic area in which the real estate is located. Real estate values and real estate markets are generally affected by changes in national, regional or local economic conditions, the rate of unemployment, fluctuations in interest rates and the availability of loans to potential purchasers, changes in tax laws and other governmental statutes, regulations and policies and acts of nature, such as earthquakes and natural disasters particular to California. Additionally, commercial real estate lending typically involves larger loan principal amounts and the repayment of the loans generally is dependent, in large part, on sufficient income from the properties securing the loans to cover operating expenses and debt service. If real estate values, including values of land held for development, decline, the value of real estate collateral securing our loans could be significantly reduced. Our ability to recover on defaulted loans by foreclosing and selling the real estate collateral would then be diminished and we would be more likely to suffer losses on defaulted loans.

In addition, banking regulators now give commercial real estate loans extremely close scrutiny due to risks relating to the cyclical nature of the real estate market, and related risks for lenders with high concentrations of such loans. The regulators have required banks with relatively high levels of commercial real estate loans to implement enhanced underwriting standards, internal controls, risk management

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policies and portfolio stress testing, which has resulted in higher allowances for possible loan losses. Any increase in our allowance for loan losses would adversely affect our net income, and any requirement that we maintain higher capital levels could adversely impact our financial condition and results of operation.

***Our construction and land development loans are based upon estimates of costs and value associated with the complete project. These estimates may be inaccurate and we may be exposed to more losses on these projects than on other loans.***

At December 31, 2013, land and construction loans, including land acquisition and development totaled \$31.4 million or 3% of our loan portfolio. This amount was comprised of 17% owner occupied and 83% non-owner occupied construction and land loans. Risk of loss on a construction loan depends largely upon whether our initial estimate of the property's value at completion of construction equals or exceeds the cost of the property construction (including interest) and the availability of permanent take-out financing. During the construction phase, a number of factors can result in delays and cost overruns. Because of the uncertainties inherent in estimating construction costs, as well as the market value of the completed project, it is relatively difficult to evaluate accurately the total funds required to complete a project and the related loan-to-value ratio. As a result, construction loans often involve the disbursement of substantial funds with repayment dependent primarily on the completion of the project and the ability of the borrower to sell the property, rather than the ability of the borrower or guarantor to repay principal and interest. If estimates of value are inaccurate or if actual construction costs exceed estimates, the value of the property securing the loan may be insufficient to ensure full repayment. If our appraisal of the value of the completed project proves to be overstated, our collateral may be inadequate for the repayment of the loan upon completion of construction of the project. If we are forced to foreclose on a project prior to or at completion due to a default, there can be no assurance that we will be able to recover all of the unpaid balance of, and accrued interest on, the loan as well as related foreclosure and holding costs. In addition, we may be required to fund additional amounts to complete the project and may have to hold the property for an unspecified period of time.

***Our use of appraisals in deciding whether to make a loan on or secured by real property does not ensure the value of the real property collateral.***

In considering whether to make a loan secured by real property, we generally require an appraisal of the property. However, an appraisal is only an estimate of the value of the property at the time the appraisal is conducted, and an error in fact or judgment could adversely affect the reliability of an appraisal. In addition, events occurring after the initial appraisal may cause the value of the real estate to decrease. As a result of any of these factors the value of collateral backing a loan may be less than estimated, and if a default occurs we may not recover the outstanding balance of the loan.

***Repayment of our commercial loans is often dependent on the cash flows of the borrower, which may be unpredictable, and the collateral securing these loans may fluctuate in value.***

At December 31, 2013, commercial loans totaled \$330.1 million or 36% of our loan portfolio, (not including SBA guaranteed loans). Commercial lending involves risks that are different from those associated with residential and commercial real estate lending. Real estate lending is generally considered to be collateral based lending with loan amounts based on predetermined loan to collateral values and liquidation of the underlying real estate collateral being viewed as the primary source of repayment in the event of borrower default. Our commercial loans are primarily made based on the cash flows of the borrowers and secondarily on any underlying collateral provided by the borrowers. A borrower's cash flows may be unpredictable, and collateral securing those loans may fluctuate in value. Although commercial loans are often collateralized by equipment, inventory, accounts receivable, or other business assets, the liquidation of collateral in the event of default is often an insufficient source of repayment because

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accounts receivable may be uncollectible and inventories may be obsolete or of limited use, among other things.

***We must effectively manage our growth strategy.***

We seek to expand our franchise safely and consistently. A successful growth strategy requires us to manage multiple aspects of the business simultaneously, such as following adequate loan underwriting standards, balancing loan and deposit growth without increasing interest rate risk or compressing our net interest margin, maintaining sufficient capital, and recruiting, training and retaining qualified professionals. We may also experience a lag in profitability associated with the new branch openings.

As part of our general growth strategy, we may expand into additional communities or attempt to strengthen our position in our current markets by opening new offices, subject to any regulatory constraints on our ability to open new offices. To the extent that we are able to open additional offices, we are likely to experience the effects of higher operating expenses relative to operating income from the new operations for a period of time, which may have an adverse effect on our levels of reported net income, return on average equity and return on average assets. Our current growth strategies involve internal growth from our current offices and, subject to any regulatory constraints on our ability to open new branch offices, the addition of new offices over time, so that the additional overhead expenses associated with these openings are absorbed prior to opening other new offices.

***Potential acquisitions may disrupt our business and adversely affect our results of operations.***

We have in the past and, subject to any regulatory constraints on our ability to undertake any acquisitions, we may in the future seek to grow our business by acquiring other businesses. We cannot predict the frequency, size or timing of our acquisitions, and we typically do not comment publicly on a possible acquisition until we have signed a definitive agreement. There can be no assurance that our acquisitions will have the anticipated positive results, including results related to the total cost of integration, the time required to complete the integration, the amount of longer-term cost savings, continued growth, or the overall performance of the acquired company or combined entity. Integration of an acquired business can be complex and costly. If we are not able to successfully integrate future acquisitions, there is a risk that our results of operations could be adversely affected. In addition, if goodwill recorded in connection with potential future acquisitions was determined to be impaired, then we would be required to recognize a charge against operations, which could materially and adversely affect our results of operations during the period in which the impairment was recognized.

***We have a significant deferred tax asset and cannot assure that it will be fully realized.***

Deferred tax assets and liabilities are the expected future tax amounts for the temporary differences between the carrying amounts and tax basis of assets and liabilities computed using enacted tax rates. We regularly assess available positive and negative evidence to determine whether it is more likely than not that our net deferred tax asset will be realized. Realization of a deferred tax asset requires us to apply significant judgment and is inherently speculative because it requires estimates that cannot be made with certainty. At December 31, 2013, we had a net deferred tax asset of \$23.3 million. If we were to determine at some point in the future that we will not achieve sufficient future taxable income to realize our net deferred tax asset, we would be required, under generally accepted accounting principles, to establish a full or partial valuation allowance which would require us to incur a charge to operations for the period in which the determination was made.

***We may be adversely affected by the soundness of other financial institutions.***

Our ability to engage in routine funding transactions could be adversely affected by the actions and liquidity of other financial institutions. Financial institutions are often interconnected as a result of trading,

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clearing, counterparty, or other business relationships. We have exposure to many different industries and counterparties, and routinely execute transactions with counterparties in the financial services industry, including commercial banks, brokers and dealers, investment banks, and other institutional clients. Many of these transactions expose us to credit risk in the event of a default by a counterparty or client. Even if the transactions are collateralized, credit risk could exist if the collateral held by us cannot be liquidated at prices sufficient to recover the full amount of the credit or derivative exposure due to us. Any such losses could adversely affect our business, financial condition or results of operations.

***We face strong competition from financial service companies and other companies that offer banking services.***

We face substantial competition in all phases of our operations from a variety of different competitors. Our competitors, including larger commercial banks, community banks, savings and loan associations, mutual savings banks, credit unions, consumer finance companies, insurance companies, securities dealers, brokers, mortgage bankers, investment advisors, money market mutual funds and other financial institutions, compete with lending and deposit gathering services offered by us. Many of these competing institutions have much greater financial and marketing resources than we have. Due to their size, many competitors can achieve larger economies of scale and may offer a broader range of products and services than we can. If we are unable to offer competitive products and services, our business may be negatively affected. Some of the financial services organizations with which we compete are not subject to the same degree of regulation as is imposed on bank holding companies and federally insured financial institutions or are not subject to increased supervisory oversight arising from regulatory examinations. As a result, these non-bank competitors have certain advantages over us in accessing funding and in providing various services.

We anticipate intense competition will be continued for the coming year due to the recent consolidation of many financial institutions and more changes in legislature, regulation and technology. Further, we expect loan demand to continue to be challenging due to the uncertain economic climate and the intensifying competition for creditworthy borrowers, both of which could lead to loan rate concession pressure and could impact our ability to generate profitable loans. We expect we may see tighter competition in the industry as banks seek to take market share in the most profitable customer segments, particularly the small business segment and the mass-affluent segment, which offers a rich source of deposits as well as more profitable and less risky customer relationships. Further, with the rebound of the equity markets, our deposit customers may perceive alternative investment opportunities as providing superior expected returns. Technology and other changes have made it more convenient for bank customers to transfer funds into alternative investments or other deposit accounts such as online virtual banks and non-bank service providers. The current low interest rate environment could increase such transfers of deposits to higher yielding deposits or other investments. Efforts and initiatives we undertake to retain and increase deposits, including deposit pricing, can increase our costs. When our customers move money into higher yielding deposits or in favor of alternative investments, we can lose a relatively inexpensive source of funds, thus increasing our funding costs.

New technology and other changes are allowing parties to effectuate financial transactions that previously required the involvement of banks. For example, consumers can maintain funds in brokerage accounts or mutual funds that would have historically been held as bank deposits. Consumers can also complete transactions such as paying bills and transferring funds directly without the assistance of banks. The process of eliminating banks as intermediaries, known as "disintermediation," could result in the loss of fee income, as well as the loss of customer deposits and the related income generated from those deposits. The loss of these revenue streams and access to lower cost deposits as a source of funds could have a material adverse effect on our financial condition and results of operations.

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***We are subject to extensive government regulation that could limit or restrict our activities, which in turn may adversely impact our ability to increase our assets and earnings.***

We operate in a highly regulated environment and are subject to supervision and regulation by a number of governmental regulatory agencies, including the Federal Reserve, the DFI and the FDIC. Regulations adopted by these agencies, which are generally intended to provide protection for depositors and customers rather than for the benefit of shareholders, govern a comprehensive range of matters relating to ownership and control of our shares, our acquisition of other companies and businesses, permissible activities for us to engage in, maintenance of adequate capital levels, and other aspects of our operations. These bank regulators possess broad authority to prevent or remedy unsafe or unsound practices or violations of law. The laws and regulations applicable to the banking industry could change at any time and we cannot predict the effects of these changes on our business and profitability. Increased regulation could increase our cost of compliance and adversely affect profitability. Moreover, certain of these regulations contain significant punitive sanctions for violations, including monetary penalties and limitations on a bank's ability to implement components of its business plan, such as expansion through mergers and acquisitions or the opening of new branch offices. In addition, changes in regulatory requirements may add costs associated with compliance efforts. Furthermore, government policy and regulation, particularly as implemented through the Federal Reserve System, significantly affect credit conditions. As a result of the negative financial market and general economic trends, there is a potential for new federal or state laws and regulation regarding lending and funding practices and liquidity standards, and bank regulatory agencies have been and are expected to be aggressive in responding to concerns and trends identified in examinations, including the expected issuance of many formal enforcement orders. Negative developments in the financial industry and the impact of new legislation and regulation in response to those developments could negatively impact our business operations and adversely impact our financial performance.

***Technology is continually changing and we must effectively implement new technologies.***

The financial services industry is undergoing rapid technological changes with frequent introductions of new technology driven products and services. In addition to better serving customers, the effective use of technology increases efficiency and enables us to reduce costs. Our future success will depend in part upon our ability to address the needs of our customers by using technology to provide products and services that will satisfy customer demands for convenience as well as to create additional efficiencies in our operations as we continue to grow and expand our market areas. In order to anticipate and develop new technology, we employ a qualified staff of internal information system specialists and consider this area a core part of our business. We do not develop our own software products, but have been able to respond to technological changes in a timely manner through association with leading technology vendors. We must continue to make substantial investments in technology which may affect our results of operations. If we are unable to make such investments, or we are unable to respond to technological changes in a timely manner, our operating costs may increase which could adversely affect our results of operations.

***System failure or breaches of our network security could subject us to increased operating costs as well as litigation and other liabilities.***

The computer systems and network infrastructure we use could be vulnerable to unforeseen problems. Our operations are dependent upon our ability to protect our computer equipment against damage from physical theft, fire, power loss, telecommunications failure or a similar catastrophic event, as well as from security breaches, denial of service attacks, viruses, worms and other disruptive problems caused by hackers. Any damage or failure that causes an interruption in our operations could have a material adverse effect on our financial condition and results of operations. Computer break-ins and other disruptions could also jeopardize the security of information stored in and transmitted through our computer systems and network infrastructure, which may result in significant liability to us and may cause existing and potential

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customers to refrain from doing business with us. We employ external auditors to conduct auditing and testing for weaknesses in our systems, controls, firewalls and encryption to reduce the likelihood of any security failures or breaches. Although we, with the help of third party service providers and auditors, intend to continue to implement security technology and establish operational procedures to prevent such damage, there can be no assurance that these security measures will be successful. In addition, advances in computer capabilities, new discoveries in the field of cryptography or other developments could result in a compromise or breach of the algorithms we and our third party service providers use to encrypt and protect customer transaction data. A failure of such security measures could have a material adverse effect on our financial condition and results of operations.

***We rely on third-party vendors for important aspects of our operation.***

We depend on the accuracy and completeness of information provided by certain key vendors, including but not limited to data processing, payroll processing, technology support, investment security safekeeping, credit stress modeling, and accounting. Our ability to operate, as well as our financial condition and results of operations, could be negatively affected in the event of an interruption of an information system, an undetected error, or in the event of a natural disaster whereby certain vendors are unable to maintain business continuity.

***We are exposed to the risk of environmental liabilities with respect to properties to which we take title.***

In the course of our business, when a borrower defaults on a loan secured by real property, we generally purchase the property in foreclosure or accept a deed to the property surrendered by the borrower. We may also take over the management of properties when owners have defaulted on loans. While we have guidelines intended to exclude properties with an unreasonable risk of contamination, hazardous substances may exist on some of the properties that we own, manage or occupy and unknown hazardous risks could impact the value of real estate collateral. We may be held liable to a governmental entity or to third parties for property damage, personal injury, investigation and clean-up costs incurred by these parties in connection with environmental contamination, or may be required to investigate or clean up hazardous or toxic substances, or chemical releases at a property. The costs associated with investigation or remediation activities could be substantial and exceed the value of the property. In addition, if we are the owner or former owner of a contaminated site, we may be subject to common law claims by third parties based on damages and costs resulting from environmental contamination emanating from the property. If we become subject to significant environmental liabilities, our business, financial condition, results of operations and prospects could be adversely affected.

***Managing operational risk is important to attracting and maintaining customers, investors and employees.***

Operational risk represents the risk of loss resulting from our operations, including but not limited to, the risk of fraud by employees or persons outside the Company, the execution of unauthorized transactions by employees, transaction processing errors and breaches of the internal control system and compliance requirements. This risk of loss also includes the potential legal actions that could arise as a result of an operational deficiency or as a result of noncompliance with applicable regulatory standards, adverse business decisions or their implementation and customer attrition due to potential negative publicity. Operational risk is inherent in all business activities and the management of this risk is important to the achievement of our business objectives. In the event of a breakdown in our internal control system, improper operation of systems or improper employee actions, we could suffer financial loss, face regulatory action and suffer damage to our reputation.

***Reputational risk can adversely affect our business.***

Threats to our reputation can come from many sources, including adverse sentiment about financial institutions generally, unethical practices, employee misconduct, failure to deliver minimum standards of

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service or quality, compliance deficiencies, and questionable or fraudulent activities of our customers. We have policies and procedures in place to protect our reputation and promote ethical conduct, but these policies and procedures may not be fully effective. Negative publicity regarding our business, employees, or customers, with or without merit, may result in the loss of customers, investors and employees, costly litigation, a decline in revenues and increased governmental regulation.

***We are dependent on key personnel and the loss of one or more of those key personnel may materially and adversely affect our prospects.***

Competition for qualified employees and personnel in the banking industry is intense and there are a limited number of qualified persons with knowledge of, and experience in, the California community banking industry. The process of recruiting personnel with the combination of skills and attributes required to carry out our strategies is often lengthy. Our success depends to a significant degree upon our ability to attract and retain qualified management, loan origination, finance, administrative, marketing and technical personnel and upon the continued contributions of our management and personnel. In particular, our success has been and continues to be highly dependent upon the abilities of key executives, including our Chief Executive Officer and certain other key employees.

***Severe weather, natural disasters, acts of war or terrorism and other external events could significantly impact our business***

Severe weather, natural disasters, acts of war or terrorism and other adverse external events could have a significant impact on our ability to conduct business. Such events could affect the stability of our deposit base, impair the ability of borrowers to repay outstanding loans, impair the value of collateral securing loans, cause significant property damage, result in loss of revenue and/or cause us to incur additional expenses. For example, our primary market areas in California are subject to earthquakes and fires. Operations in our market could be disrupted by both the evacuation of large portions of the population as well as damage and or lack of access to our banking and operation facilities. While we have not experienced such an occurrence to date, other severe weather or natural disasters, acts of war or terrorism or other adverse external events may occur in the future. Although management has established disaster recovery policies and procedures, the occurrence of any such event could have a material adverse effect on our business, which, in turn, could have a material adverse effect on our financial condition and results of operations.

#### **Risks Related to Our Securities**

***Our securities are not an insured deposit.***

Our securities are not bank deposits and, therefore, are not insured against loss by the FDIC, any other deposit insurance fund or by any other public or private entity. Investment in our securities is inherently risky for the reasons described in this section and elsewhere in this report and is subject to the same market forces that affect the price of securities in any company.

***Our outstanding Series C Preferred Stock impacts net income available to our common shareholders and earnings per common share, and conversion of our Series C Preferred Stock will be dilutive to holders of our common stock.***

The dividends declared and the accretion on our outstanding Series C Preferred Stock reduce the net income available to common shareholders and our earnings per common share. Our Series C Preferred Stock will also receive preferential treatment in the event of our liquidation, dissolution or winding up. The ownership interest of our existing holders of common stock will be diluted to the extent our Series C Preferred Stock is automatically converted into common stock. The Series C Preferred Stock is convertible into an aggregate of 5,601,000 shares of our common stock upon a transfer of the Series C Preferred Stock to a transferee not affiliated with the holder in a widely dispersed offering. The shares of common stock

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underlying the Series C Preferred Stock represent approximately 21% of the shares of our common stock outstanding on December 31, 2013.

***The price of our common stock may fluctuate significantly, and this may make it difficult for you to resell shares of common stock owned by you at times or at prices you find attractive.***

The stock market and, in particular, the market for financial institution stocks, have experienced significant volatility. In some cases, the markets have produced downward pressure on stock prices for certain issuers without regard to those issuers' underlying financial strength. As a result, the trading volume in our common stock may fluctuate more than usual and cause significant price variations to occur.

The trading price of the shares of our common stock will depend on many factors, which may change from time to time and which may be beyond our control, including, without limitation, our financial condition, performance, creditworthiness and prospects, future sales or offerings of our equity or equity related securities, and other factors identified above under "Cautionary Note Regarding Forward Looking Statements," "Risk Factors" and below. These broad market fluctuations have adversely affected and may continue to adversely affect the market price of our common stock. Among the factors that could affect our stock price are:

actual or anticipated quarterly fluctuations in our operating results and financial condition;

changes in financial estimates or publication of research reports and recommendations by financial analysts or actions taken by rating agencies with respect to our common stock or those of other financial institutions;

failure to meet analysts' revenue or earnings estimates;

speculation in the press or investment community generally or relating to our reputation, our operations, our market area, our competitors or the financial services industry in general;

strategic actions by us or our competitors, such as acquisitions, restructurings, dispositions or financings;

actions by our current shareholders, including institutional investors;

fluctuations in the stock price and operating results of our competitors;

future sales of our equity, equity related or debt securities;

proposed or adopted regulatory changes or developments;

anticipated or pending investigations, proceedings, or litigation that involve or affect us;

trading activities in our common stock, including short selling;

domestic and international economic factors unrelated to our performance; and

general market conditions and, in particular, developments related to market conditions for the financial services industry.



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Our common stock is listed for trading on the NASDAQ Global Select Market under the symbol "HTBK." The trading volume has historically been significantly less than that of larger financial services companies. Stock price volatility may make it more difficult for you to sell your common stock when you want and at prices you find attractive.

A public trading market having the desired characteristics of depth, liquidity and orderliness depends on the presence in the marketplace of willing buyers and sellers of our common stock at any given time. This presence depends on the individual decisions of investors and general economic and market conditions over which we have no control. Given the relatively low trading volume of our common stock,

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significant sales of our common stock in the public market, or the perception that those sales may occur, could cause the trading price of our common stock to decline or to be lower than it otherwise might be in the absence of those sales or perceptions.

***Federal and state law may limit the ability of another party to acquire us, which could cause the price of our securities to decline.***

Federal law prohibits a person or group of persons "acting in concert" from acquiring "control" of a bank holding company unless the Federal Reserve has been given 60 days prior written notice of such proposed acquisition and within that time period the Federal Reserve has not issued a notice disapproving the proposed acquisition or extending for up to another 30 days the period during which such a disapproval may be issued. An acquisition may be made prior to the expiration of the disapproval period if the Federal Reserve issues written notice of its intent not to disapprove the action. Under a rebuttable presumption established by the Federal Reserve, the acquisition of 10% or more of a class of voting stock of a bank or bank holding company with a class of securities registered under Section 12 of the Exchange Act would, under the circumstances set forth in the presumption, constitute the acquisition of control. In addition, any "company" would be required to obtain the approval of the Federal Reserve under the BHCA, before acquiring 25% (5% in the case of an acquirer that is, or is deemed to be, a bank holding company) or more of any class of voting stock, or such lesser number of shares as may constitute control.

Under the California Financial Code, no person may, directly or indirectly, acquire control of a California state bank or its holding company unless the DFI has approved such acquisition of control. A person would be deemed to have acquired control of HBC if such person, directly or indirectly, has the power (i) to vote 25% or more of the voting power of Heritage Bank of Commerce; or (ii) to direct or cause the direction of the management and policies of HBC. For purposes of this law, a person who directly or indirectly owns or controls 10% or more of our outstanding common stock would be presumed to control HBC.

These provisions of federal and state law may prevent a merger or acquisition that would be attractive to shareholders and could limit the price investors would be willing to pay in the future for our securities.

***We may raise additional capital, which could have a dilutive effect on the existing holders of our securities and adversely affect the market price of our securities.***

We are not restricted from issuing additional shares of common stock or securities that are convertible into or exchangeable for, or represent the right to receive shares of common stock. We frequently evaluate opportunities to access the capital markets taking into account our regulatory capital ratios, financial condition and other relevant considerations and, subject to market conditions, we may take further capital actions. Such actions could include, among other things, the issuance of additional shares of common stock or other securities in public or private transactions in order to further increase our capital levels above the requirements for a "well capitalized" institution established by the federal bank regulatory agencies as well as other regulatory targets. These issuances could dilute ownership interests of investors and could dilute the per share book value of our common stock.

***The issuance of additional shares of preferred stock could adversely affect holders of common stock, which may negatively impact an investment in our securities.***

Our Board of Directors is authorized to issue additional classes or series of preferred stock without any action on the part of the shareholders, except in certain circumstances. Our Board of Directors also has the power, without shareholder approval except in certain circumstances, to set the terms of any such classes or series of preferred stock that may be issued, including voting rights, dividend rights and preferences over the common stock with respect to dividends or upon the liquidation, dissolution or winding up of our business and other terms. If we issue preferred stock in the future that has a preference over the common stock with respect to the payment of dividends or upon liquidation, dissolution or winding up, or if we issue preferred stock with voting rights that dilute the voting power of the common stock, then the rights of holders of the common stock or the market price of the common stock could be adversely affected.

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**ITEM 1B UNRESOLVED STAFF COMMENTS**

None.

**ITEM 2 PROPERTIES**

The main and executive offices of HCC and HBC are located at 150 Almaden Boulevard in San Jose, California 95113, with branch offices located at 15575 Los Gatos Boulevard in Los Gatos, California 95032, at 387 Diablo Road in Danville, California 94526, at 3137 Stevenson Boulevard in Fremont, California 94538, at 300 Main Street in Pleasanton, California 94566, at 101 Ygnacio Valley Road in Walnut Creek, California 94596, at 18625 Sutter Boulevard in Morgan Hill, California 95037, at 7598 Monterey Street in Gilroy, California 95020, at 419 S. San Antonio Road in Los Altos, California 94022, and at 333 W. El Camino Real in Sunnyvale, California 94087. The Company also has an SBA loan production office located at 851 Sterling Parkway, Lincoln, California 95648.

**Main Offices**

The main offices of HBC are located at 150 Almaden Boulevard in San Jose, California on the first three floors in a fifteen-story Class-A type office building. All three floors, consisting of approximately 35,547 square feet, are subject to a direct lease dated April 13, 2000, as amended, which expires on May 31, 2015. The current monthly rent payment for the first two floors, consisting of approximately 22,723 square feet, is \$63,927 and is subject to 3% annual increases until the lease expires. The current monthly rent payment for the third floor, which consists of approximately 12,824 square feet, is \$53,861 until the lease expires. The Company has reserved the right to extend the term of the lease for two additional periods of five years each.

In January of 1997, the Company leased approximately 1,255 square feet (referred to as the "Kiosk") located next to the primary operating area at 150 Almaden Boulevard in San Jose, California to be used for meetings, staff training and marketing events. The current monthly rent payment is \$5,271 until the lease expires on May 31, 2015. The Company has reserved the right to extend the term of the lease for two additional periods of five years each.

**Branch Offices**

In March of 1999, the Company leased approximately 7,260 square feet in a one-story multi-tenant office building located at 18625 Sutter Boulevard in Morgan Hill, California. The current monthly rent payment is \$12,427 until the lease expires on October 31, 2014.

In May of 2006, the Company leased approximately 2,505 square feet on the first floor in a three-story multi-tenant multi-use building located at 7598 Monterey Street in Gilroy, California. The current monthly rent payment is \$5,180 and is subject to annual increases of 2% until the lease expires on September 30, 2016. The Company has reserved the right to extend the term of the lease for two additional periods of five years each.

In April of 2007, the Company leased approximately 3,850 square feet on the first floor in a four-story multi-tenant office building located at 101 Ygnacio Valley Road in Walnut Creek, California. The current monthly rent payment is \$15,170 until the lease expires on August 15, 2014. The Company has reserved the right to extend the term of the lease for one additional period of five years.

In June of 2007, as part of the acquisition of Diablo Valley Bank, the Company took ownership of an 8,285 square foot one-story commercial office building, including the land, located at 387 Diablo Road in Danville, California.

In June of 2008, the Company leased approximately 5,213 square feet on the first floor in a two-story multi-tenant office building located at 419 S. San Antonio Road in Los Altos, California. The current

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monthly rent payment is \$25,236 and is subject to annual increases of 3% until the lease expires on April 30, 2018. The Company has reserved the right to extend the term of the lease for two additional periods of five years each.

In October of 2013, the Company extended its lease for approximately 1,920 square feet in a one-story stand-alone building located in an office complex at 15575 Los Gatos Boulevard in Los Gatos, California. The current monthly rent payment is \$5,664 and is subject to annual increases of 3% until the lease expires on November 30, 2018. The Company has reserved the right to extend the term of the lease for one additional period of five years.

In September of 2010, the Company extended its lease for approximately 4,096 square feet in a one-story stand-alone office building located at 300 Main Street in Pleasanton, California. The current monthly rent payment is \$15,665 and is subject to annual increases of 3% until the lease expires on October 31, 2017.

In September of 2012, the Company leased, effective March 1, 2013, approximately 3,172 square feet in a one-story multi-tenant multi-use building located at 3137 Stevenson Boulevard in Fremont, California. The monthly rent payment is \$6,820 and is subject to annual increases of 3% until the lease expires on February 29, 2020. The Company has reserved the right to extend the term of the lease for one additional period of four years and another additional period of three years.

In June of 2013, the Company leased approximately 3,022 square feet on the first floor of a three-story multi-tenant office building located at 333 West El Camino Real in Sunnyvale, California. The current monthly rent payment is \$11,333 and is subject to annual increases of 3% until the lease expires on May 31, 2018. The Company has reserved the right to extend the term of the lease for one additional period of five years.

**Loan Production Office**

In October of 2013, the Company leased approximately 150 square feet of office space located at 851 Sterling Parkway in Lincoln, California. The current monthly rent payment is \$350 until the lease expires on April 4, 2014. The Company has reserved the right to extend the lease on a month-to-month basis.

For additional information on operating leases and rent expense, refer to Note 6 to the Consolidated Financial Statements following "Item 15 *Exhibits and Financial Statement Schedules.*"

**ITEM 3 LEGAL PROCEEDINGS**

The Company is involved in certain legal actions arising from normal business activities. Management, based upon the advice of legal counsel, believes the ultimate resolution of all pending legal actions will not have a material effect on the financial statements of the Company.

**ITEM 4 MINE SAFETY DISCLOSURES**

Not Applicable.

Table of Contents**PART II****ITEM 5 MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES****Market Information**

The Company's common stock is listed on the NASDAQ Global Select Market under the symbol "HTBK." Management is aware of the following securities dealers which make a market in the Company's common stock: Credit Suisse Securities USA, UBS Securities LLC, LATOUR TRADING LLC, Deutsche Banc Alex Brown, SG Americas Securities LLC, MORGAN STANLEY & CO. LLC, Fig Partners, LLC, Dart Executions, LLC, Merrill Lynch, Pierce, Fenner, VIRTU FINANCIAL BD LLC, INSTINET, LLC, Goldman, Sachs & Co., WEDBUSH SECURITIES INC, Susquehanna Capital Group, Interactive Brokers LLC, Barclays Capital Inc./Le, Citigroup Global Markets Inc., J.P. Morgan Securities LLC, Wedbush Securities Inc., Citadel Securities LLC, Knight Capital Americas LLC, BNP Paribas Securities Corp., RBC Capital Market Corp., Keefe, Bruyette & Woods, Inc., Sandler O'Neill & Partners, D.A. Davidson & Co., Investment Technology Group, Knight Capital Americas LLC, Octeg, LLC, and Two Sigma Securities, LLC. These market makers have committed to make a market for the Company's common stock, although they may discontinue making a market at any time. No assurance can be given that an active trading market will be sustained for the common stock at any time in the future.

The information in the following table for 2013 and 2012 indicates the high and low closing prices for the common stock, based upon information provided by the NASDAQ Global Select Market and cash dividend payment for each quarter presented.

| Quarter                              | Stock Price |         | Dividend<br>Per Share |
|--------------------------------------|-------------|---------|-----------------------|
|                                      | High        | Low     |                       |
| <b>Year ended December 31, 2013:</b> |             |         |                       |
| Fourth quarter                       | \$ 8.33     | \$ 7.20 | \$ 0.03               |
| Third quarter                        | \$ 7.65     | \$ 6.85 | \$ 0.03               |
| Second quarter                       | \$ 7.08     | \$ 6.36 | \$                    |
| First quarter                        | \$ 7.03     | \$ 6.42 | \$                    |
| <b>Year ended December 31, 2012:</b> |             |         |                       |
| Fourth quarter                       | \$ 7.10     | \$ 6.36 | \$                    |
| Third quarter                        | \$ 7.11     | \$ 5.96 | \$                    |
| Second quarter                       | \$ 6.75     | \$ 5.96 | \$                    |
| First quarter                        | \$ 6.44     | \$ 4.59 | \$                    |

The closing price of our common stock on February 7, 2014 was \$8.05 per share as reported by the NASDAQ Global Select Market.

As of February 7, 2014, there were approximately 609 holders of record of common stock. There are no other classes of common equity outstanding.

**Dividend Policy**

The amount of future dividends will depend upon our earnings, financial condition, capital requirements and other factors, and will be determined by our board of directors on a quarterly basis. It is Federal Reserve policy that bank holding companies generally pay dividends on common stock only out of income available over the past year, and only if prospective earnings retention is consistent with the organization's expected future needs and financial condition. It is also Federal Reserve policy that bank holding companies not maintain dividend levels that undermine the holding company's ability to be a source of strength to its banking subsidiaries. Additionally, in consideration of the current financial and economic environment, the Federal Reserve has indicated that bank holding companies should carefully

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review their dividend policy and has discouraged payment ratios that are at maximum allowable levels unless both asset quality and capital are very strong. Under the federal Prompt Corrective Action regulations, the Federal Reserve or the FDIC may prohibit a bank holding company from paying any dividends if the holding company's bank subsidiary is classified as undercapitalized.

As a holding company, our ability to pay cash dividends is affected by the ability of our bank subsidiary, HBC, to pay cash dividends. The ability of HBC (and our ability) to pay cash dividends in the future and the amount of any such cash dividends is and could be in the future further influenced by bank regulatory requirements and approvals and capital guidelines.

The decision whether to pay dividends will be made by our Board of Directors in light of conditions then existing, including factors such as our results of operations, financial condition, business conditions, regulatory capital requirements and covenants under any applicable contractual arrangements, including agreements with regulatory authorities.

For information on the statutory and regulatory limitations on the ability of the Company to pay dividends and on HBC to pay dividends to HCC see "*Item 1 Business Supervision and Regulation Dividends.*"

**Securities Authorized for Issuance Under Equity Compensation Plans**

The following table provides information as of December 31, 2013 regarding equity compensation plans under which equity securities of the Company were authorized for issuance:

|  | Number of securities to<br>be issued upon exercise<br>of<br>outstanding options,<br>warrants and rights<br>(a) | Weighted average<br>exercise price of<br>outstanding<br>options,<br>warrants and rights<br>(b) | Number of securities<br>remaining available for<br>future issuance under<br>equity compensation<br>plans<br>(excluding securities<br>reflected in column (a))<br>(c) |
|--|--|--|--|
| Equity compensation plans approved by security holders     | 1,506,504(1)   | \$11.80  | 1,727,500(2)   |
| Equity compensation plans not approved by security holders | N/A  | N/A  | N/A  |

(1) Consists of 37,810 options to acquire shares of common stock issued under the Company's 1994 stock option plan, and 1,446,194 options to acquire shares under the Company's Amended and Restated 2004 Equity Plan and 22,500 options to acquire shares under the Company's 2013 Equity Incentive Plan

(2) Available under the Company's 2013 Equity Incentive Plan.

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**Performance Graph**

The following graph compares the stock performance of the Company from December 31, 2008 to December 31, 2013, to the performance of several specific industry indices. The performance of the S&P 500 Index, NASDAQ Stock Index and NASDAQ Bank Stocks were used as comparisons to the Company's stock performance. Management believes that a performance comparison to these indices provides meaningful information and has therefore included those comparisons in the following graph.

The following chart compares the stock performance of the Company from December 31, 2008 to December 31, 2013, to the performance of several specific industry indices. The performance of the S&P 500 Index, NASDAQ Stock Index and NASDAQ Bank Stocks were used as comparisons to the Company's stock performance.

| Index                   | Period Ending |          |          |          |          |          |
|-------------------------|---------------|----------|----------|----------|----------|----------|
|                         | 12/31/08      | 12/31/09 | 12/31/10 | 12/31/11 | 12/31/12 | 12/31/13 |
| Heritage Commerce Corp* | 100           | 36       | 40       | 42       | 62       | 73       |
| S&P 500*                | 100           | 123      | 139      | 139      | 158      | 205      |
| NASDAQ Total US*        | 100           | 144      | 168      | 165      | 191      | 265      |
| NASDAQ Bank Index*      | 100           | 81       | 91       | 80       | 92       | 128      |

\*

Source: SNL Financial Bank Information Group (434) 977-1600

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The following table presents a summary of selected financial information that should be read in conjunction with the Company's consolidated financial statements and notes thereto included under Item 8 "FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA."

**SELECTED FINANCIAL DATA**

|  | AT OR FOR YEAR ENDED DECEMBER 31, |            |            |             |             |
|--|-----------------------------------|------------|------------|-------------|-------------|
|  | 2013                              | 2012       | 2011       | 2010        | 2009        |
| <b>(Dollars in thousands, except per share data)</b>                           |                                   |            |            |             |             |
| <b>INCOME STATEMENT DATA:</b>  |                                   |            |            |             |             |
| Interest income  | \$ 52,786                         | \$ 52,565  | \$ 52,031  | \$ 55,087   | \$ 62,293   |
| Interest expense   | 2,600                             | 4,187      | 5,875      | 10,512      | 16,326      |
| Net interest income before provision for loan losses                           | 50,186                            | 48,378     | 46,156     | 44,575      | 45,967      |
| Provision (credit) for loan losses   | (816)                             | 2,784      | 4,469      | 26,804      | 33,928      |
| Net interest income after provision for loan losses                            | 51,002                            | 45,594     | 41,687     | 17,771      | 12,039      |
| Noninterest income   | 7,214                             | 8,865      | 8,422      | 8,733       | 8,027       |
| Noninterest expense  | 41,722                            | 40,256     | 39,572     | 88,127      | 44,760      |
| Income (loss) before income taxes  | 16,494                            | 14,203     | 10,537     | (61,623)    | (24,694)    |
| Income tax expense (benefit)   | 4,954                             | 4,294      | (834)      | (5,766)     | (12,709)    |
| Net income (loss)  | 11,540                            | 9,909      | 11,371     | (55,857)    | (11,985)    |
| Dividends and discount accretion on preferred stock                            | (336)                             | (1,206)    | (2,333)    | (2,398)     | (2,376)     |
| Net income (loss) available to common shareholders                             | 11,204                            | 8,703      | 9,038      | (58,255)    | (14,361)    |
| Less: undistributed earnings allocated to Series C Preferred Stock             | 1,687                             | 1,527      | 1,589      | N/A         | N/A         |
| Distributed and undistributed earnings (loss) allocated to common shareholders | \$ 9,517                          | \$ 7,176   | \$ 7,449   | \$ (58,255) | \$ (14,361) |
| <b>PER COMMON SHARE DATA:</b>  |                                   |            |            |             |             |
| Basic net income (loss)(1)   | \$ 0.36                           | \$ 0.27    | \$ 0.28    | \$ (3.64)   | \$ (1.21)   |
| Diluted net income (loss)(2)   | \$ 0.36                           | \$ 0.27    | \$ 0.28    | \$ (3.64)   | \$ (1.21)   |
| Book value per common share(3)   | \$ 5.84                           | \$ 5.71    | \$ 5.30    | \$ 4.73     | \$ 11.34    |
| Tangible book value per common share(4)  | \$ 5.78                           | \$ 5.63    | \$ 5.20    | \$ 4.61     | \$ 7.38     |
| Pro forma tangible book value per share, assuming Series C                     |                                   |            |            |             |             |
| Preferred Stock was converted into common stock(5)                             | \$ 5.38                           | \$ 5.25    | \$ 4.90    | \$ 4.41     | \$ 7.38     |
| Weighted average number of shares outstanding basic                            | 26,338,161                        | 26,303,245 | 26,266,584 | 16,026,058  | 11,820,509  |
| Weighted average number of shares outstanding diluted                          | 26,386,452                        | 26,329,336 | 26,270,394 | 16,026,058  | 11,820,509  |
| Shares outstanding at period end   | 26,350,938                        | 26,322,147 | 26,295,001 | 26,233,001  | 11,820,509  |
| Pro forma common shares outstanding at period end, assuming Series C           |                                   |            |            |             |             |
| Preferred Stock was converted into common stock(6)                             | 31,951,938                        | 31,923,147 | 31,896,001 | 31,834,001  | 11,820,509  |
| <b>BALANCE SHEET DATA:</b>   |                                   |            |            |             |             |



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|  |              |              |              |              |              |
|--|--------------|--------------|--------------|--------------|--------------|
| Securities (available-for sale and held-to-maturity)                                 | \$ 376,021   | \$ 419,384   | \$ 380,455   | \$ 232,165   | \$ 109,966   |
| Net loans  | \$ 895,749   | \$ 793,286   | \$ 743,891   | \$ 820,845   | \$ 1,041,345 |
| Allowance for loan losses  | \$ 19,164    | \$ 19,027    | \$ 20,700    | \$ 25,204    | \$ 28,768    |
| Goodwill and other intangible assets   | \$ 1,527     | \$ 2,000     | \$ 2,491     | \$ 3,014     | \$ 46,770    |
| Total assets   | \$ 1,491,632 | \$ 1,693,312 | \$ 1,306,194 | \$ 1,246,369 | \$ 1,363,870 |
| Total deposits   | \$ 1,286,221 | \$ 1,479,368 | \$ 1,049,428 | \$ 993,918   | \$ 1,089,285 |
| Securities sold under agreement to repurchase  | \$           | \$           | \$           | \$ 5,000     | \$ 25,000    |
| Subordinated debt  | \$           | \$ 9,279     | \$ 23,702    | \$ 23,702    | \$ 23,702    |
| Short-term borrowings  | \$           | \$           | \$           | \$ 2,445     | \$ 20,000    |
| Total shareholders' equity   | \$ 173,396   | \$ 169,741   | \$ 197,831   | \$ 182,152   | \$ 172,305   |
| <b>SELECTED PERFORMANCE RATIOS:(7)</b>   |              |              |              |              |              |
| Return (loss) on average assets  | 0.81%        | 0.73%        | 0.89%        | -4.17%       | -0.83%       |
| Return (loss) on average tangible assets   | 0.81%        | 0.73%        | 0.89%        | -4.25%       | -0.86%       |
| Return (loss) on average equity  | 6.77%        | 5.75%        | 6.02%        | -30.82%      | -6.68%       |
| Return (loss) on average tangible equity   | 6.84%        | 5.83%        | 6.11%        | -35.66%      | -9.06%       |
| Net interest margin  | 3.84%        | 3.88%        | 3.94%        | 3.69%        | 3.53%        |
| Efficiency ratio, excluding impairment of goodwill                                   | 72.69%       | 70.32%       | 72.51%       | 84.31%       | 82.90%       |
| Average net loans (excludes loans held-for-sale) as a percentage of average deposits | 67.26%       | 67.98%       | 75.91%       | 87.53%       | 98.98%       |
| Average total shareholders' equity as a percentage of average total assets           | 11.90%       | 12.72%       | 14.82%       | 13.55%       | 12.46%       |
| <b>SELECTED ASSET QUALITY DATA:(8)</b>   |              |              |              |              |              |
| Net (recoveries) charge-offs to average loans  | -0.11%       | 0.57%        | 1.12%        | 3.18%        | 2.59%        |
| Allowance for loan losses to total loans   | 2.09%        | 2.34%        | 2.71%        | 2.98%        | 2.69%        |
| Nonperforming loans to total loans plus nonaccrual loans                             | 1.29%        | 2.24%        | 2.20%        | 3.90%        | 5.83%        |
| Nonperforming assets   | \$ 12,393    | \$ 19,464    | \$ 19,142    | \$ 34,399    | \$ 64,616    |
| <b>CAPITAL RATIOS:</b>   |              |              |              |              |              |
| Total risk-based   | 15.3%        | 16.2%        | 21.9%        | 20.9%        | 12.9%        |
| Tier 1 risk-based  | 14.0%        | 15.0%        | 20.6%        | 19.7%        | 11.6%        |
| Leverage   | 11.2%        | 11.5%        | 15.3%        | 14.1%        | 10.1%        |

Notes:

- (1) Represents distributed and undistributed earnings (loss) allocated to common shareholders, divided by the average number of shares of common stock outstanding for the respective period. See Note 15 to the consolidated financial statements.

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- (2) Represents distributed and undistributed earnings (loss) allocated to common shareholders, divided by the average number of shares of common stock and common stock-equivalents outstanding for the respective period. See Note 15 to the consolidated financial statements.
- (3) Represents shareholders' equity minus preferred stock divided by the number of shares of common stock outstanding at the end of the period indicated.
- (4) Represents shareholders' equity minus preferred stock, minus goodwill and other intangible assets divided by the number of shares of common stock outstanding at the end of period indicated.
- (5) Represents shareholders' equity minus preferred stock, minus goodwill and other intangible assets divided by the number of shares of common stock outstanding at the end of period indicated, assuming 21,004 shares of Series C Preferred Stock were converted into 5,601,000 shares of common stock.
- (6) Assumes 21,004 shares of Series C Preferred Stock were converted into 5,601,000 shares of common stock at December 31, 2013, 2012, 2011, and 2010.
- (7) Average balances used in this table and throughout this Annual Report are based on daily averages.
- (8) Average loans and total loans exclude loans held-for-sale.

**ITEM 7 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The following discussion provides information about the results of operations, financial condition, liquidity, and capital resources of HCC and its wholly-owned subsidiary, HBC. This information is intended to facilitate the understanding and assessment of significant changes and trends related to our financial condition and the results of operations. This discussion and analysis should be read in conjunction with our consolidated financial statements and the accompanying notes presented elsewhere in this report.

**Critical Accounting Policies**

*General*

The Company's consolidated financial statements are prepared in accordance with accounting policies generally accepted in the United States of America and general practices in the banking industry. The financial statements include the accounts of the Company. All inter-company accounts and transactions have been eliminated in consolidation.

*Use of Estimates*

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The allowance for loan losses, carrying value of foreclosed assets, deferred tax assets and liabilities, intangible assets, loan servicing rights, interest-only strip receivables, defined benefit pension and split-dollar life insurance benefit plan and the fair values of financial instruments are particularly subject to change.

*Allowance for Loan Losses*

The allowance for loan losses is an estimate of the losses in our loan portfolio. The allowance is only an estimate of the inherent loss in the loan portfolio and may not represent actual losses realized over time, either of losses in excess of the allowance or of losses less than the allowance. Our accounting for estimated loan losses is discussed under the heading "*Allowance for Loan Losses*" and disclosed primarily in Notes 1 and 4 to the consolidated financial statements.

*Loan Sales and Servicing*

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The amounts of gains recorded on sales of loans and the initial recording of servicing assets and I/O strips are based on the estimated fair values of the respective components. In recording the initial value of the servicing assets and the fair value of the I/O strips receivable, the Company uses estimates which are

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made on management's expectations of future prepayment and discount rates as discussed in Notes 1 and 4 to the consolidated financial statements.

***Stock Based Compensation***

We grant stock options to purchase our common stock also to our employees and directors under the 2013 Equity Incentive Plan. Additionally, we have outstanding options that were granted under option plans from which we no longer make grants. The benefits provided under all of these plans are subject to the provisions of accounting guidance related to share-based payments. Our results of operations for fiscal years 2013, 2012, and 2011 were impacted by the recognition of non-cash expense related to the fair value of our share-based compensation awards.

The determination of fair value of stock-based payment awards on the date of grant using the Black-Scholes model is affected by our stock price, as well as the input of other subjective assumptions. These assumptions include, but are not limited to, the expected term of stock options and our stock price volatility. Our stock options have characteristics significantly different from those of traded options, and changes in the assumptions can materially affect the fair value estimates.

Accounting guidance requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. If actual forfeitures vary from our estimates, we will recognize the difference in compensation expense in the period the actual forfeitures occur.

Our accounting for stock options is disclosed primarily in Notes 1 and 11 to the consolidated financial statements.

***Deferred Tax Assets***

Our net deferred income tax asset arises from temporary differences between the carrying amount of assets and liabilities reported in the financial statements and the amounts used for income tax return purposes. Our accounting for deferred tax assets is discussed under the heading "*Income Tax Expense*" and disclosed primarily in Notes 1 and 10 to the consolidated financial statements.

**Executive Summary**

This summary is intended to identify the most important matters on which management focuses when it evaluates the financial condition and performance of the Company. When evaluating financial condition and performance, management looks at certain key metrics and measures. The Company's evaluation includes comparisons with peer group financial institutions and its own performance objectives established in the internal planning process.

The primary activity of the Company is commercial banking. The Company's operations are located in the southern and eastern regions of the general San Francisco Bay Area of California in the counties of Santa Clara, Alameda and Contra Costa. The largest city in this area is San Jose and the Company's market includes the headquarters of a number of technology based companies in the region known commonly as Silicon Valley. The Company also has an SBA loan production office in the Sacramento, California area. The Company's customers are primarily closely held businesses and professionals.

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*Performance Overview*

For the year ended December 31, 2013, net income was \$11.5 million and net income available to common shareholders was \$11.2 million, or \$0.36 per average diluted common share, which included dividends on preferred stock of \$336,000.<sup>(1)</sup> For the year ended December 31, 2012, net income was \$9.9 million and net income available to common shareholders was \$8.7 million, or \$0.27 per average diluted common share, which included dividends and discount accretion on preferred stock of \$1.2 million. For the year ended December 31, 2011, net income was \$11.4 million and net income available to common shareholders was \$9.0 million, or \$0.28 per average diluted common share, which included a reversal of the \$3.7 million partial valuation allowance for deferred tax assets that was established in 2010, and dividends and discount accretion of preferred stock of \$2.3 million.

*Significant 2013 Events*

During the third quarter of 2013, the Company completed the redemption of its \$9.3 million floating-rate subordinated debt. The Company used available cash and proceeds from a \$9.3 million distribution from the Bank for the redemption.

The Company distributed a \$0.03 per share quarterly cash dividend to holders of common stock and Series C preferred stock (on an as converted basis) in the third and fourth quarters of 2013, and distributed a \$0.04 per share quarterly cash dividend in the first quarter of 2014.

The following are major factors that impacted the Company's results of operations:

The net interest margin, on a full tax equivalent basis, decreased 4 basis points to 3.84% for the year ended December 31, 2013, compared to 3.88% for the year ended December 31, 2012. The decrease in the net interest margin for 2013, compared to 2012 was primarily due to a lower yield on loans, and a higher average balance of short-term deposits at the Federal Reserve Bank.

Net interest income increased 4% to \$50.2 million for the year ended December 31, 2013, compared to \$48.4 million for the year ended December 31, 2012, primarily due to an increase in the average balance of loans and a lower cost of funds.

Asset quality and net recoveries resulted in a credit to the provision for loan losses of \$816,000 for the year ended December 31, 2013, compared to a provision for loan losses of \$2.8 million for the year ended December 31, 2012. The decrease in the provision for loan losses in 2013 compared to 2012 reflects the improvement in credit quality.

Noninterest income decreased to \$7.2 million for the year ended December 31, 2013, compared to \$8.9 million for the year ended December 31, 2012. The decrease was primarily due to a lower gain on sales of securities and SBA loans, and lower servicing income.

Noninterest expense was \$41.7 million for the year ended December 31, 2013, compared to \$40.3 million, for the year ended December 31, 2012. The increase in noninterest expense for the year ended December 31, 2013, compared to the same period a year ago, reflects increased salaries

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(1)

In our previously reported results for the year ended December 31, 2013 filed with our Current Report on Form 8-K with the SEC on January 27, 2014, we did not include the 2013 third and fourth quarter cash dividend paid to holders of Series C Preferred stock in dividends and discount accretion on preferred stock. The result of including the cash dividend paid to holders of Series C Preferred Stock had the following effect on our previously reported results: (i) net income available to common shareholders was reduced by \$168,000 for the third quarter of 2013; (ii) net income available to common shareholders was reduced by \$168,000 for the fourth

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quarter of 2013; and (iii) net income available to common shareholders was reduced by \$336,000 for the year ended December 31, 2013. There were no changes to basic net income per share and diluted net income per share for the respective periods.

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and employee benefits expense due to annual merit increases and hiring of additional lending relationship officers.

The efficiency ratio was 72.69% for the year ended December 31, 2013, compared to 70.32% for the year ended December 31, 2012.

Income tax expense for the year ended December 31, 2013 was \$5.0 million, compared to \$4.3 million for the year ended December 31, 2012, and an income tax benefit of \$834,000 for the year ended December 31, 2011. Income tax expense for the year ended December 31, 2013 was higher than for the year ended December 31, 2012, due to pre-tax income being higher by a comparable amount. The income tax benefit for the year ended December 31, 2011 included the reversal of the \$3.7 million partial valuation allowance for deferred tax assets that was established in 2010.

The following are important factors in understanding our current financial condition and liquidity position:

Cash, interest-bearing deposits in other financial institutions and securities available-for-sale decreased 47% to \$392.7 million at December 31, 2013, compared to \$741.5 million at December 31, 2012. Excluding the Company's excess funds held at the Federal Reserve Bank offsetting the short-term deposits of \$46.5 million at December 31, 2013, and \$271.9 million at December 31, 2012, cash, interest-bearing deposits in other financial institutions and securities available-for-sale at December 31, 2013 decreased 26% from December 31, 2012.

Securities held-to-maturity, at amortized cost, were \$95.9 million at December 31, 2013, compared to \$51.5 million at December 31, 2012. The increase in the investment securities held-to-maturity portfolio at December 31, 2013, from December 31, 2012, was primarily due to purchases of higher yielding municipal bonds with favorable tax benefits, which the Company intends to hold until maturity.

Total loans, excluding loans held-for-sale, increased \$102.6 million, or 13%, to \$914.9 million at December 31, 2013, compared to \$812.3 million at December 31, 2012.

Classified assets (net of SBA guarantees) decreased 36% to \$23.6 million at December 31, 2013, compared to \$36.8 million at December 31, 2012.

The allowance for loan losses at December 31, 2013 was \$19.2 million, or 2.09% of total loans, representing 162.16% of nonperforming loans. The allowance for loan losses at December 31, 2012 was \$19.0 million, or 2.34% of total loans, representing 104.58% of nonperforming loans.

Nonperforming assets were \$12.4 million, or 0.83% of total assets at December 31, 2013, compared to \$19.5 million, or 1.15% of total assets at December 31, 2012.

Net loan recoveries were \$953,000 for the year ended December 31, 2013, compared to net loan charge-offs of \$4.5 million for the year ended December 31, 2012.

Total deposits decreased 13% to \$1.29 billion at December 31, 2013, compared to \$1.48 billion at December 31, 2012. Deposits (excluding all time deposits, CDARS deposits, and short-term deposits from one customer of \$19.0 million at December 31, 2013 and \$271.9 million at December 31, 2012) increased \$70.8 million, or 8%, to \$954.6 million at December 31, 2013, from \$883.8 million at December 31, 2012.

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The ratio of noncore funding (which consists of time deposits \$100,000 and over, CDARS deposits, brokered deposits, securities under agreement to repurchase and short-term borrowings) to total assets was 19.51% at December 31, 2013, compared to 17.63% at December 31, 2012. Excluding the Company's excess funds held at the Federal Reserve Bank offsetting the short-term deposits of \$46.5 million at December 31, 2013, and \$271.9 million at December 31, 2012, the ratio



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of noncore funding to total assets was 18.23% at December 31, 2013, and 21.00% at December 31, 2012.

The loan to deposit ratio was 71.13% at December 31, 2013, compared to 54.91% at December 31, 2012. The loan to deposit ratio was 73.80% at December 31, 2013, and 67.27% at December 31, 2012, excluding the short-term deposits of \$46.5 million and \$271.9 million at the respective periods.

Although the redemption of the \$9.3 million floating-rate subordinated debt reduced regulatory capital levels, capital ratios exceed regulatory requirements for a well-capitalized financial institution at the holding company and bank level at December 31, 2013:

| Capital Ratios    | Heritage<br>Commerce<br>Corp | Heritage Bank<br>of Commerce | Well-Capitalized<br>Financial Institution<br>Regulatory Guidelines |
|-------------------|------------------------------|------------------------------|--|
| Total Risk-Based  | 15.3%                        | 13.9%                        | 10.0%  |
| Tier 1 Risk-Based | 14.0%                        | 12.6%                        | 6.0%   |
| Leverage          | 11.2%                        | 10.1%                        | 5.0%   |

### *Deposits*

The composition and cost of the Company's deposit base are important in analyzing the Company's net interest margin and balance sheet liquidity characteristics. Except for brokered time deposits, the Company's depositors are generally located in its primary market area. Depending on loan demand and other funding requirements, the Company also obtains deposits from wholesale sources including deposit brokers. HBC is a member of the Certificate of Deposit Account Registry Service ("CDARS") program. The CDARS program allows customers with deposits in excess of FDIC insured limits to obtain coverage on time deposits through a network of banks within the CDARS program. Deposits gathered through this program are considered brokered deposits under regulatory guidelines. The Company has a policy to monitor all deposits that may be sensitive to interest rate changes to help assure that liquidity risk does not become excessive due to concentrations.

During the fourth quarters of both 2013 and 2012, the Company received a significantly large amount of deposits from one customer, which were placed in the Bank on a short-term basis. As a result of the short-term nature of the deposits, the funds were placed in low interest earning deposits at the Federal Reserve Bank. In the fourth quarter of 2013, these deposits totaled \$194.1 million in a combination of noninterest-bearing demand deposit and money market accounts, of which \$19.0 million remained in a money market account at December 31, 2013. In the fourth quarter of 2012, these deposits totaled \$467.5 million in a noninterest-bearing demand deposit account, of which \$195.6 million were withdrawn prior to year end, for a net outstanding balance of \$271.9 million at December 31, 2012. An additional \$233.7 million of these deposits were withdrawn in January 2013, as originally planned by the customer.

During the fourth quarter of 2013, the Company received \$27.5 million in deposits from a law firm for legal settlements which were placed in a CDARS money market account. All of the \$27.5 million in deposits from the law firm were withdrawn in the first quarter of 2014. As a result of the short-term nature of the deposits, these funds were also placed in low interest earning deposits at the Federal Reserve Bank.

The Company had \$55.5 million in brokered deposits at December 31, 2013, compared to \$97.8 million at December 31, 2012. Deposits from title insurance companies, escrow accounts and real estate exchange facilitators increased to \$37.6 million at December 31, 2013, compared to \$21.4 million at December 31, 2012. Certificates of deposit from the State of California totaled \$98.0 million at December 31, 2013, compared to \$85.0 million at December 31, 2012. Primarily due to \$27.5 million in deposits received from a law firm for legal settlements, CDARS money market and time deposits increased to \$40.5 million at December 31, 2013, compared to \$10.2 million at December 31, 2012. Deposits (excluding all time deposits, CDARS deposits, and short-term deposits from one customer of \$19.0 million

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at December 31, 2013 and \$271.9 million at December 31, 2012) increased \$70.8 million, or 8%, to \$954.6 million at December 31, 2013, from \$883.8 million at December 31, 2012.

***Liquidity***

Our liquidity position refers to our ability to maintain cash flows sufficient to fund operations and to meet obligations and other commitments in a timely fashion. At December 31, 2013, we had \$112.6 million in cash and cash equivalents and approximately \$421.8 million in available borrowing capacity from various sources including the FHLB, the FRB, and Federal funds facilities with several financial institutions. The Company also had \$222.5 million in unpledged securities available at December 31, 2013. Our loan to deposit ratio increased to 71.13% at December 31, 2013, compared to 54.91% at December 31, 2012, primarily due to an increase in loans and the large demand deposits of one customer at December 31, 2012. The loan to deposit ratio was 73.80% at December 31, 2013, and 67.27% at December 31, 2012, excluding the short-term deposits of \$46.5 million and \$271.9 million at the respective periods.

***Lending***

Our lending business originates primarily through our branch offices located in our primary markets. The Company also has an additional SBA loan production office in Lincoln, California. Total loans, excluding loans held-for-sale, increased \$102.6 million, or 13%, to \$914.9 million at December 31, 2013, compared to \$812.3 million at December 31, 2012. The total loan portfolio remains well diversified with commercial and industrial ("C&I") loans accounting for 43% of the portfolio at December 31, 2013. Commercial and residential real estate loans accounted for 46% of the total loan portfolio at December 31, 2013, of which 48% were owner-occupied by businesses. Consumer and home equity loans accounted for 8% of the total loan portfolio, and land and construction loans accounted for the remaining 3% of our total loan portfolio at December 31, 2013. The yield on the loan portfolio was 4.92% for the year ended December 31, 2013, compared to 5.18% for the year ended December 31, 2012. The decrease in the yield on the loan portfolio for the year ended December 31, 2013, compared to the same period in 2012, was primarily the result of lower yields on renewals.

***Net Interest Income***

The management of interest income and expense is fundamental to the performance of the Company. Net interest income, the difference between interest income and interest expense, is the largest component of the Company's total revenue. Because of our focus on commercial lending to closely held businesses, the Company will continue to have a high percentage of floating rate loans and other assets. Management closely monitors both total net interest income and the net interest margin (net interest income divided by average earning assets).

The Company, through its asset and liability policies and practices, seeks to maximize net interest income without exposing the Company to an excessive level of interest rate risk. Interest rate risk is managed by monitoring the pricing, maturity and repricing options of all classes of interest bearing assets and liabilities. This is discussed in more detail under "*Liquidity and Asset/Liability Management.*" In addition, we believe there are measures and initiatives we can take to improve the net interest margin, including increasing loan rates, adding floors on floating rate loans, reducing nonperforming assets, managing deposit interest rates, and reducing higher cost deposits.

The net interest margin is also adversely impacted by the reversal of interest on nonaccrual loans and the reinvestment of loan payoffs into lower yielding investment securities and other short-term investments.

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***Management of Credit Risk***

We continue to proactively identify, quantify, and manage our problem loans. Early identification of problem loans and potential future losses helps enable us to resolve credit issues with potentially less risk and ultimate losses. We maintain an allowance for loan losses in an amount that we believe is adequate to absorb probable incurred losses in the portfolio. While we strive to carefully manage and monitor credit quality and to identify loans that may be deteriorating, circumstances can change at any time for loans included in the portfolio that may result in future losses, that as of the date of the financial statements have not yet been identified as potential problem loans. Through established credit practices, we adjust the allowance for loan losses accordingly. However, because future events are uncertain, there may be loans that deteriorate some of which could occur in an accelerated time frame. As a result, future additions to the allowance for loan losses may be necessary. Because the loan portfolio contains a number of commercial loans, commercial real estate, construction and land development loans with relatively large balances, deterioration in the credit quality of one or more of these loans may require a significant increase to the allowance for loan losses. Future additions to the allowance may also be required based on changes in the financial condition of borrowers, such as have resulted due to the current, and potentially worsening, economic conditions. Additionally, Federal and state banking regulators, as an integral part of their supervisory function, periodically review our allowance for loan losses. These regulatory agencies may require us to recognize further loan loss provisions or charge-offs based upon their judgments, which may be different from ours. Any increase in the allowance for loan losses would have an adverse effect, which may be material, on our financial condition and results of operation.

Further discussion of the management of credit risk appears under "*Provision for Loan Losses*" and "*Allowance for Loan Losses*."

***Noninterest Income***

While net interest income remains the largest single component of total revenues, noninterest income is an important component. A portion of the Company's noninterest income is associated with its SBA lending activity, consisting of gains on the sale of loans sold in the secondary market and servicing income from loans sold with servicing retained. Other sources of noninterest income include loan servicing fees, service charges and fees, cash surrender value from company owned life insurance policies, and gains on the sale of securities.

***Noninterest Expense***

Management considers the control of operating expenses to be a critical element of the Company's performance. The Company has undertaken several initiatives to reduce its noninterest expense and improve its efficiency. Noninterest expense for the year ended December 31, 2013 was \$41.7 million, compared to \$40.3 million a year ago. The increase in noninterest expense for the year ended December 31, 2013, compared to the same period a year ago, reflects increased salaries and employee benefits expense due to annual salary increases and hiring of additional lending relationship officers.

***Capital Management***

As part of its asset and liability management process, the Company continually assesses its capital position to take into consideration growth, expected earnings, risk profile and potential corporate activities that it may choose to pursue.

On November 21, 2008, the Company issued to the U.S. Treasury under its Capital Purchase Program 40,000 shares of Series A Preferred Stock for \$40.0 million and issued a warrant to purchase 462,963 shares of common stock at an exercise price of \$12.96.

On June 21, 2010, HCC issued to various institutional investors 53,996 shares of Series B Mandatorily Convertible Cumulative Perpetual Preferred Stock ("Series B Preferred Stock") and 21,004 shares of

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Series C Convertible Perpetual Preferred Stock ("Series C Preferred Stock") for an aggregate purchase price of \$75 million. On September 16, 2010, the Series B Preferred Stock in accordance with its terms was converted into 14,398,992 shares of common stock of HCC at a conversion price of \$3.75 per share, and the shares of Series B Preferred Stock ceased to be outstanding. The Series C Preferred Stock remains outstanding and is convertible into 5,601,000 shares of common stock. The Series C Preferred Stock is non-voting except in the case of certain transactions that would affect the rights of the holders of the Series C Preferred Stock or applicable law. Holders of Series C Preferred Stock will receive dividends if and only to the extent dividends are paid to holders of common stock.

On March 7, 2012, in accordance with approvals received from the U.S. Treasury and the Federal Reserve, the Company repurchased all shares of the Series A Preferred Stock and paid the related accrued and unpaid dividends. The repurchase of the Series A Preferred Stock eliminates \$2.0 million in annual dividends. On June 12, 2013, the Company completed the repurchase of the common stock warrant for \$140,000.

During the third quarter of 2012, the Company completed the redemption of \$14 million fixed-rate subordinated debt, and during the third quarter of 2013, the Company completed the redemption of its remaining \$9 million of floating rate subordinated debt.

**Results of Operations**

The Company earns income from two primary sources. The first is net interest income, which is interest income generated by earning assets less interest expense on interest-bearing liabilities. The second is noninterest income, which primarily consists of gains on the sale of loans, loan servicing fees, customer service charges and fees, the increase in cash surrender value of life insurance, and gains on the sale of securities. The majority of the Company's noninterest expenses are operating costs that relate to providing a full range of banking services to our customers.

***Net Interest Income and Net Interest Margin***

The level of net interest income depends on several factors in combination, including growth in earning assets, yields on earning assets, the cost of interest-bearing liabilities, the relative volumes of earning assets and interest-bearing liabilities, and the mix of products that comprise the Company's earning assets, deposits, and other interest-bearing liabilities. Net interest income can also be impacted by the reversal of interest on loans placed on nonaccrual status, and recovery of interest on loans that have been on nonaccrual and are either sold or returned to accrual status. To maintain its net interest margin, the Company must manage the relationship between interest earned and paid.

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The following Distribution, Rate and Yield table presents for each of the past three years, the average amounts outstanding for the major categories of the Company's balance sheet, the average interest rates earned or paid thereon, and the resulting net interest margin on average interest earning assets for the periods indicated. Average balances are based on daily averages.

### Distribution, Rate and Yield

|  | Year Ended December 31, |                                |                           |                     |                                |                           |                     |                                |                           |
|--|-------------------------|--------------------------------|---------------------------|---------------------|--------------------------------|---------------------------|---------------------|--------------------------------|---------------------------|
|  | 2013                    |                                |                           | 2012                |                                |                           | 2011                |                                |                           |
|  | Average<br>Balance      | Interest<br>Income/<br>Expense | Average<br>Yield/<br>Rate | Average<br>Balance  | Interest<br>Income/<br>Expense | Average<br>Yield/<br>Rate | Average<br>Balance  | Interest<br>Income/<br>Expense | Average<br>Yield/<br>Rate |
| (Dollars in thousands)   |                         |                                |                           |                     |                                |                           |                     |                                |                           |
| <b>Assets:</b>   |                         |                                |                           |                     |                                |                           |                     |                                |                           |
| Loans, gross(1)  | \$ 845,303              | \$ 41,570                      | 4.92%                     | \$ 787,032          | \$ 40,800                      | 5.18%                     | \$ 804,068          | \$ 42,769                      | 5.32%                     |
| Securities taxable   | 339,778                 | 9,472                          | 2.79%                     | 404,913             | 11,519                         | 2.84%                     | 297,231             | 9,088                          | 3.06%                     |
| Securities tax exempt(2)   | 61,636                  | 2,355                          | 3.83%                     | 4,575               | 172                            | 3.77%                     |                     |                                | N/A                       |
| Federal funds sold and interest-bearing deposits in other financial institutions | 83,219                  | 214                            | 0.26%                     | 52,500              | 134                            | 0.26%                     | 68,878              | 174                            | 0.25%                     |
| <b>Total interest earning assets(2)</b>  | <b>1,329,936</b>        | <b>53,611</b>                  | <b>4.03%</b>              | <b>1,249,020</b>    | <b>52,625</b>                  | <b>4.21%</b>              | <b>1,170,177</b>    | <b>52,031</b>                  | <b>4.45%</b>              |
| Cash and due from banks  | 23,510                  |                                |                           | 21,583              |                                |                           | 21,077              |                                |                           |
| Premises and equipment, net  | 7,500                   |                                |                           | 7,774               |                                |                           | 8,022               |                                |                           |
| Goodwill and other intangible assets   | 1,774                   |                                |                           | 2,258               |                                |                           | 2,762               |                                |                           |
| Other assets   | 68,678                  |                                |                           | 72,799              |                                |                           | 73,172              |                                |                           |
| <b>Total assets</b>  | <b>\$ 1,431,398</b>     |                                |                           | <b>\$ 1,353,434</b> |                                |                           | <b>\$ 1,275,210</b> |                                |                           |
| <b>Liabilities and shareholders' equity:</b>                                     |                         |                                |                           |                     |                                |                           |                     |                                |                           |
| <b>Deposits:</b>   |                         |                                |                           |                     |                                |                           |                     |                                |                           |
| Demand, noninterest-bearing  | \$ 427,299              |                                |                           | \$ 392,131          |                                |                           | \$ 334,676          |                                |                           |
| Demand, interest-bearing   | 172,615                 | 246                            | 0.14%                     | 150,476             | 223                            | 0.15%                     | 133,538             | 238                            | 0.18%                     |
| Savings and money market   | 308,510                 | 544                            | 0.18%                     | 288,980             | 611                            | 0.21%                     | 279,250             | 892                            | 0.32%                     |
| Time deposits under \$100  | 23,069                  | 80                             | 0.35%                     | 27,337              | 132                            | 0.48%                     | 31,549              | 230                            | 0.73%                     |
| Time deposits \$100 and Over   | 194,587                 | 747                            | 0.38%                     | 167,804             | 958                            | 0.57%                     | 131,756             | 1,298                          | 0.99%                     |
| Time deposits brokered   | 75,968                  | 745                            | 0.98%                     | 91,278              | 867                            | 0.95%                     | 92,278              | 1,217                          | 1.32%                     |
| CDARS money market and time deposits   | 17,996                  | 7                              | 0.04%                     | 5,756               | 9                              | 0.16%                     | 16,403              | 67                             | 0.41%                     |
| <b>Total interest-bearing deposits</b>   | <b>792,745</b>          | <b>2,369</b>                   | <b>0.30%</b>              | <b>731,631</b>      | <b>2,800</b>                   | <b>0.38%</b>              | <b>684,774</b>      | <b>3,942</b>                   | <b>0.58%</b>              |
| <b>Total deposits</b>  | <b>1,220,044</b>        | <b>2,369</b>                   | <b>0.19%</b>              | <b>1,123,762</b>    | <b>2,800</b>                   | <b>0.25%</b>              | <b>1,019,450</b>    | <b>3,942</b>                   | <b>0.39%</b>              |
| Subordinated debt  | 5,816                   | 229                            | 3.94%                     | 19,052              | 1,383                          | 7.26%                     | 23,702              | 1,871                          | 7.89%                     |
| Securities sold under agreement to repurchase                                    |                         |                                | N/A                       |                     |                                | N/A                       | 712                 | 24                             | 3.37%                     |
| Short-term borrowings  | 129                     | 2                              | 1.55%                     | 1,518               | 4                              | 0.26%                     | 933                 | 38                             | 4.07%                     |
| <b>Total interest-bearing liabilities</b>  | <b>798,690</b>          | <b>2,600</b>                   | <b>0.33%</b>              | <b>752,201</b>      | <b>4,187</b>                   | <b>0.56%</b>              | <b>710,121</b>      | <b>5,875</b>                   | <b>0.83%</b>              |

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|  |           |       |       |           |       |       |           |       |       |
|--|-----------|-------|-------|-----------|-------|-------|-----------|-------|-------|
| Total interest-bearing liabilities and demand, noninterest-bearing / cost of funds | 1,225,989 | 2,600 | 0.21% | 1,144,332 | 4,187 | 0.37% | 1,044,797 | 5,875 | 0.56% |
| Other liabilities  | 35,018    |       |       | 36,909    |       |       | 41,473    |       |       |

|                      |           |  |  |           |  |  |           |  |  |
|----------------------|-----------|--|--|-----------|--|--|-----------|--|--|
| Total liabilities    | 1,261,007 |  |  | 1,181,241 |  |  | 1,086,270 |  |  |
| Shareholders' equity | 170,391   |  |  | 172,193   |  |  | 188,940   |  |  |

|  |              |  |  |              |  |  |              |  |  |
|--|--------------|--|--|--------------|--|--|--------------|--|--|
| Total liabilities and shareholders' equity | \$ 1,431,398 |  |  | \$ 1,353,434 |  |  | \$ 1,275,210 |  |  |
|--|--------------|--|--|--------------|--|--|--------------|--|--|

|                                   |  |        |       |  |        |       |  |        |       |
|-----------------------------------|--|--------|-------|--|--------|-------|--|--------|-------|
| Net interest income(2) / margin   |  | 51,011 | 3.84% |  | 48,438 | 3.88% |  | 46,156 | 3.94% |
| Less tax equivalent adjustment(2) |  | (825)  |       |  | (60)   |       |  |        |       |

|                     |  |           |  |  |           |  |  |           |  |
|---------------------|--|-----------|--|--|-----------|--|--|-----------|--|
| Net interest income |  | \$ 50,186 |  |  | \$ 48,378 |  |  | \$ 46,156 |  |
|---------------------|--|-----------|--|--|-----------|--|--|-----------|--|

- 
- (1) Includes loans held-for-sale. Yields and amounts earned on loans include loan fees and costs. Nonaccrual loans are included in average balance.
- (2) Reflects tax equivalent adjustment for tax exempt income based on a 35% federal tax rate.

The Volume and Rate Variances table below sets forth the dollar difference in interest earned and paid for each major category of interest-earning assets and interest-bearing liabilities for the noted periods, and the amount of such change attributable to changes in average balances (volume) or changes in average interest rates. Volume variances are equal to the increase or decrease in the average balance multiplied by

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prior period rates and rate variances are equal to the increase or decrease in the average rate multiplied by the prior period average balance. Variances attributable to both rate and volume changes are equal to the change in rate multiplied by the change in average balance and are included below in the average volume column.

**Volume and Rate Variances**

|  | 2013 vs. 2012<br>Increase (Decrease)<br>Due to Change in: |                   |                 | 2012 vs. 2011<br>Increase (Decrease)<br>Due to Change in: |                 |                 |
|--|---|-------------------|-----------------|---|-----------------|-----------------|
|  | Average<br>Volume   | Average<br>Rate   | Net<br>Change   | Average<br>Volume   | Average<br>Rate | Net<br>Change   |
| <b>(Dollars in thousands)</b>  |   |                   |                 |   |                 |                 |
| <b>Income from the interest earning assets:</b>                                  |   |                   |                 |   |                 |                 |
| Loans, gross   | \$ 2,848  | \$ (2,078)        | \$ 770          | \$ (851)  | \$ (1,118)      | \$ (1,969)      |
| Securities taxable   | (1,825)   | (222)             | (2,047)         | 3,078   | (647)           | 2,431           |
| Securities tax exempt(1)   | 2,180   | 3                 | 2,183           | 172   |                 | 172             |
| Federal funds sold and interest-bearing deposits in other financial institutions | 77  | 3                 | 80              | (45)  | 5               | (40)            |
| <b>Total interest income on interest earning assets(1)</b>                       | <b>3,280</b>  | <b>(2,294)</b>    | <b>986</b>      | <b>2,354</b>  | <b>(1,760)</b>  | <b>594</b>      |
| <b>Expense from the interest-bearing liabilities:</b>                            |   |                   |                 |   |                 |                 |
| Demand, interest-bearing   | 35  | (12)              | 23              | 23  | (38)            | (15)            |
| Savings and money market   | 24  | (91)              | (67)            | 25  | (306)           | (281)           |
| Time deposits under \$100  | (16)  | (36)              | (52)            | (19)  | (79)            | (98)            |
| Time deposits \$100 and over   | 109   | (320)             | (211)           | 207   | (547)           | (340)           |
| Time deposits brokered   | (150)   | 28                | (122)           | (10)  | (340)           | (350)           |
| CDARS money market and time deposits   | 5   | (7)               | (2)             | (17)  | (41)            | (58)            |
| Subordinated debt  | (522)   | (632)             | (1,154)         | (338)   | (150)           | (488)           |
| Securities sold under agreement to repurchase                                    |   |                   |                 | (24)  |                 | (24)            |
| Short-term borrowings  | (22)  | 20                | (2)             | 2   | (36)            | (34)            |
| <b>Total interest expense on interest-bearing liabilities</b>                    | <b>(537)</b>  | <b>(1,050)</b>    | <b>(1,587)</b>  | <b>(151)</b>  | <b>(1,537)</b>  | <b>(1,688)</b>  |
| <b>Net interest income(1)</b>  | <b>\$ 3,817</b>   | <b>\$ (1,244)</b> | <b>2,573</b>    | <b>\$ 2,505</b>   | <b>\$ (223)</b> | <b>2,282</b>    |
| <b>Less tax equivalent adjustment(1)</b>   |   |                   | <b>(765)</b>    |   |                 | <b>(60)</b>     |
| <b>Net interest income</b>   |   |                   | <b>\$ 1,808</b> |   |                 | <b>\$ 2,222</b> |

(1) Reflects tax equivalent adjustment for tax exempt income based on a 35% federal tax rate.

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The Company's net interest margin, expressed as a percentage of average earning assets was 3.84% for 2013, a decrease of 4 basis points compared to 3.88% for 2012, principally due to a lower yield on loans, and a higher average balance of short-term deposits at the Federal Reserve Bank. The Company's net interest margin for 2012 decreased 6 basis points from 3.94% for 2011, principally due to lower yields on loans and securities, partially offset by a lower cost of funds.

Net interest income for the year ended December 31, 2013 increased \$1.8 million to \$50.2 million, compared to \$48.4 million a year ago, primarily due to an increase in the average balance of loans and a lower cost of funds. Net interest income for the year ended December 31, 2012 increased \$2.2 million to



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\$48.4 million, compared to \$46.2 million for the year ended December 31, 2011, primarily due to a an increase in the average balance of investment securities, and a decrease in the rates paid on interest-bearing liabilities, partially offset by a decrease in the average balance of loans.

A substantial portion of the Company's earning assets are variable-rate loans that re-price when the Company's prime lending rate is changed, in contrast to a large base of core deposits that are generally slower to re-price. This causes the Company's balance sheet to be asset-sensitive which means that, all else being equal, the Company's net interest margin will be lower during periods when short-term interest rates are falling and higher when rates are rising.

***Provision for Loan Losses***

Credit risk is inherent in the business of making loans. The Company establishes an allowance for loan losses through charges to earnings, which are shown in the statements of operations as the provision for loan losses. Specifically identifiable and quantifiable known losses are promptly charged off against the allowance. The provision for loan losses is determined by conducting a quarterly evaluation of the adequacy of the Company's allowance for loan losses and charging the shortfall, if any, to the current quarter's operations. This has the effect of creating variability in the amount and frequency of charges to the Company's earnings. The provision for loan losses and level of allowance for each period are dependent upon many factors, including loan growth, net charge-offs, changes in the composition of the loan portfolio, delinquencies, management's assessment of the quality of the loan portfolio, the valuation of problem loans and the general economic conditions in the Company's market area.

The Company had a credit to the provision for loan losses of \$816,000 for the year ended December 31, 2013, compared to a provision for loan losses of \$2.8 million for the year ended December 31, 2012, and a provision for loan losses of \$4.5 million for the year ended December 31, 2011. The decrease in the provision for loan losses in 2013 compared to 2012 and 2011 was primarily the result of net recoveries in 2013, combined with improvement in credit quality, partially offset by loan growth.

The allowance for loan losses represented 2.09%, 2.34% and 2.71% of total loans at December 31, 2013, 2012 and 2011, respectively. The decrease in the allowance for loan losses to total loans at December 31, 2013, compared to prior periods, was primarily due to a decline in problem loans, as well as a decline in historical charge-off levels. Annualized net recoveries as a percentage of average loans were -0.11% as of December 31, 2013, as compared to net charge-offs as a percentage of average loans of 0.57% as of December 31, 2012, and net charge-offs as a percentage of average loans of 1.12% as of December 31, 2011. Provisions for loan losses are charged to operations to bring the allowance for loan losses to a level deemed appropriate by the Company based on the factors discussed under "*Allowance for Loan Losses.*"

Table of Contents**Noninterest Income**

The following table sets forth the various components of the Company's noninterest income:

|  | Year Ended December 31, |                 |                 | Increase<br>(decrease)<br>2013 versus 2012 |             | Increase<br>(decrease)<br>2012 versus 2011 |           |
|--|-------------------------|-----------------|-----------------|--|-------------|--|-----------|
|  | 2013                    | 2012            | 2011            | Amount                                     | Percent     | Amount                                     | Percent   |
| (Dollars in thousands)                             |                         |                 |                 |  |             |  |           |
| Service charges and fees on deposit accounts       | \$ 2,457                | \$ 2,333        | \$ 2,355        | \$ 124                                     | 5%          | \$ (22)                                    | -1%       |
| Increase in cash surrender value of life insurance | 1,654                   | 1,720           | 1,706           | (66)                                       | -4%         | 14   | 1%        |
| Servicing income                                   | 1,446                   | 1,743           | 1,743           | (297)                                      | -17%        |  | 0%        |
| Gain on sales of SBA loans                         | 449                     | 702             | 1,461           | (253)                                      | -36%        | (759)                                      | -52%      |
| Gain on sales of securities                        | 38                      | 1,560           | 459             | (1,522)                                    | -98%        | 1,101                                      | 240%      |
| Other  | 1,170                   | 807             | 698             | 363  | 45%         | 109  | 16%       |
| <b>Total</b>                                       | <b>\$ 7,214</b>         | <b>\$ 8,865</b> | <b>\$ 8,422</b> | <b>\$ (1,651)</b>                          | <b>-19%</b> | <b>\$ 443</b>                              | <b>5%</b> |

The decrease in noninterest income for the year ended December 31, 2013, compared to the year ended December 31, 2012, was primarily due to a lower gain on sales of securities and SBA loans, and lower servicing income. The increase in noninterest income for the year ended December 31, 2012, compared to the year ended December 31, 2011, was primarily due to a higher gain on sales of securities, partially offset by a lower gain on sales of SBA loans.

The Company sold \$26.9 million of agency mortgage-backed securities for a net gain of \$38,000 during the year ended December 31, 2013, compared to a \$1.6 million gain during the year ended December 31, 2012, and a \$459,000 net gain during the year ended December 31, 2011.

A portion of the Company's noninterest income is associated with its SBA lending activity, as gain on sales of loans sold in the secondary market and servicing income from loans sold with servicing rights retained. During 2013, SBA loan sales resulted in a \$449,000 gain, compared to a \$702,000 gain on sales of SBA loans in 2012, and a \$1.5 million gain on sales of SBA loans in 2011. The servicing assets that result from the sales of SBA loans with servicing retained are amortized over the expected term of the loans using a method approximating the interest method. Servicing income generally declines as the respective loans are repaid.

The increase in cash surrender value of life insurance approximates a 3.43% after tax yield on the policies. To realize this tax advantaged yield the policies must be held until death of the insured individuals, who are current and former officers and directors of the Company.

Table of Contents*Noninterest Expense*

The following table sets forth the various components of the Company's noninterest expense:

|  | Year Ended December 31, |                  |                  | Increase<br>(decrease) 2013<br>versus 2012 |           | Increase<br>(decrease) 2012<br>versus 2011 |           |
|--|-------------------------|------------------|------------------|--|-----------|--|-----------|
|  | 2013                    | 2012             | 2011             | Amount                                     | Percent   | Amount                                     | Percent   |
| (Dollars in thousands)                     |                         |                  |                  |  |           |  |           |
| Salaries and employee benefits             | \$ 23,450               | \$ 21,722        | \$ 20,574        | \$ 1,728                                   | 8%        | \$ 1,148                                   | 6%        |
| Occupancy and equipment                    | 4,043                   | 3,997            | 4,083            | 46   | 1%        | (86)                                       | -2%       |
| Professional fees                          | 2,588                   | 2,876            | 2,861            | (288)                                      | -10%      | 15   | 1%        |
| Software subscriptions                     | 1,289                   | 1,149            | 1,078            | 140  | 12%       | 71   | 7%        |
| Low income housing investment losses       | 1,252                   | 1,195            | 1,035            | 57   | 5%        | 160  | 15%       |
| Data processing                            | 1,078                   | 983              | 876              | 95   | 10%       | 107  | 12%       |
| Insurance expense                          | 1,032                   | 911              | 941              | 121  | 13%       | (30)                                       | -3%       |
| FDIC deposit insurance premiums            | 894                     | 918              | 1,294            | (24)                                       | -3%       | (376)                                      | -29%      |
| Correspondent bank charges                 | 684                     | 611              | 545              | 73   | 12%       | 66   | 12%       |
| Premium on redemption of subordinated debt |                         | 601              |                  | (601)                                      | -100%     | 601  | N/A       |
| Foreclosed assets                          | (251)                   | (45)             | 389              | (206)                                      | -458%     | (434)                                      | -112%     |
| Other                                      | 5,663                   | 5,338            | 5,896            | 325  | 6%        | (558)                                      | -9%       |
| <b>Total</b>                               | <b>\$ 41,722</b>        | <b>\$ 40,256</b> | <b>\$ 39,572</b> | <b>\$ 1,466</b>                            | <b>4%</b> | <b>\$ 684</b>                              | <b>2%</b> |

The following table indicates the percentage of noninterest expense in each category:

*Noninterest Expense by Category*

|  | 2013             |                  | 2012             |                  | 2011             |                  |
|--|------------------|------------------|------------------|------------------|------------------|------------------|
|  | Amount           | Percent of Total | Amount           | Percent of Total | Amount           | Percent of Total |
| (Dollars in thousands)                     |                  |                  |                  |                  |                  |                  |
| Salaries and employee benefits             | \$ 23,450        | 56%              | \$ 21,722        | 54%              | \$ 20,574        | 52%              |
| Occupancy and equipment                    | 4,043            | 10%              | 3,997            | 10%              | 4,083            | 10%              |
| Professional fees                          | 2,588            | 6%               | 2,876            | 7%               | 2,861            | 7%               |
| Software subscriptions                     | 1,289            | 3%               | 1,149            | 3%               | 1,078            | 3%               |
| Low income housing investment losses       | 1,252            | 3%               | 1,195            | 3%               | 1,035            | 3%               |
| Data processing                            | 1,078            | 3%               | 983              | 2%               | 876              | 2%               |
| Insurance expense                          | 1,032            | 2%               | 911              | 2%               | 941              | 3%               |
| FDIC deposit insurance premiums            | 894              | 2%               | 918              | 2%               | 1,294            | 3%               |
| Correspondent bank charges                 | 684              | 2%               | 611              | 2%               | 545              | 1%               |
| Premium on redemption of subordinated debt |                  | 0%               | 601              | 2%               |                  | 0%               |
| Foreclosed assets                          | (251)            | -1%              | (45)             | 0%               | 389              | 1%               |
| Other                                      | 5,663            | 14%              | 5,338            | 13%              | 5,896            | 15%              |
| <b>Total</b>                               | <b>\$ 41,722</b> | <b>100%</b>      | <b>\$ 40,256</b> | <b>100%</b>      | <b>\$ 39,572</b> | <b>100%</b>      |

Noninterest expense for the year ended December 31, 2013 increased 4% to \$41.7 million, compared to \$40.3 million for the year ended December 31, 2012. The increase from year to year was primarily due to increased salaries and employee benefits expense. Salaries and employee benefits increased \$1.7 million, or 8%, for the year ended December 31, 2013 from the year ended December 31, 2012, primarily due to annual merit increases and hiring of additional lending relationship officers. Full-time equivalent

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employees were 193, 190, and 189 at December 31, 2013, 2012, and 2011, respectively. Software subscriptions and data processing expense increased \$235,000, or 11%, for 2013 from 2012, primarily due to one-time system conversion costs. Other noninterest expense increased in 2013, compared to 2012 primarily due to higher credit related costs and recruiting expenses. These increases were partially offset by a decrease in the premium on redemption of subordinated debt, lower professional, fees and lower foreclosed assets expense. There was a gain on the sale of foreclosed assets of \$243,000 for 2013, compared to a gain of \$395,000 for 2012.

Noninterest expense for the year ended December 31, 2012 increased 2% to \$40.3 million, compared to \$39.6 million for the year ended December 31, 2011. The increase from year to year primarily resulted from the early pay off premium on the redemption of the \$14 million fixed-rate subordinated debt, and an increase in salaries and employee benefits. The early payoff premium on the redemption of the \$14 million fixed-rate subordinated debt resulted in a \$601,300 charge during the year ended December 31, 2012. Salaries and employee benefits increased \$1.1 million, or 6%, for the year ended December 31, 2012 from the year ended December 31, 2011, primarily due to higher health insurance premiums and the addition of seasoned bankers in our lending group. FDIC deposit insurance premiums decreased \$376,000, or 29%, for the year ended December 31, 2012, compared to 2011 due to a decrease in the FDIC deposit assessment rate as the Company's risk profile improved. Foreclosed assets expense decreased \$434,000, or 112%, for 2012, compared to 2011 due to a gain on the disposition of foreclosed assets. Other noninterest expense decreased in 2012, compared to 2011 due to lower credit related costs and management's efforts to control expenses.

***Income Tax Expense***

The Company computes its provision for income taxes on a monthly basis. The effective tax rate is determined by applying the Company's statutory income tax rates to pre-tax book income as adjusted for permanent differences between pre-tax book income and actual taxable income. These permanent differences include, but are not limited to, tax-exempt interest income, increases in the cash surrender value of life insurance policies, California Enterprise Zone deductions, certain expenses that are not allowed as tax deductions, and tax credits.

The Company's Federal and state income tax expense in 2013 was \$5.0 million, compared to \$4.3 million in 2012, and an income tax benefit of \$834,000 in 2011. The income tax benefit of \$834,000 in 2011 included the elimination of a \$3.7 million partial valuation allowance for the Company's deferred tax asset. The following table shows the effective income tax rates for the dates indicated:

|                           | <b>For the Year Ended December 31,</b> |             |             |
|---------------------------|--|-------------|-------------|
|                           | <b>2013</b>                            | <b>2012</b> | <b>2011</b> |
| Effective income tax rate | 30.0%                                  | 30.2%       | -7.9%       |

The difference in the effective tax rate compared to the combined Federal and state statutory tax rate of 42% is primarily the result of tax exempt securities, the Company's investment in life insurance policies whose earnings are not subject to taxes, tax credits related to investments in low income housing limited partnerships, Enterprise Zone tax credits, hiring credits, and the deferred tax asset valuation allowance.

The Company has total net investments of \$1.2 million in low-income housing limited partnerships as of December 31, 2013. These investments have generated annual tax credits of approximately \$727,000 for the year ended December 31, 2013, \$845,000 for the year ended December 31, 2012, and \$846,000 for the year ended December 31, 2011. The Company had California Enterprise Zone tax savings of approximately \$153,000 for the year ended December 31, 2013, \$138,000 for the year ended December 31, 2012, and \$157,000 for the year ended December 31, 2011. The California legislature eliminated the Enterprise Zone tax deduction beginning January 1, 2014.

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Some items of income and expense are recognized in different years for tax purposes than when applying generally accepted accounting principles leading to timing differences between the Company's actual tax liability, and the amount accrued for this liability based on book income. These temporary differences comprise the "deferred" portion of the Company's tax expense or benefit, which is accumulated on the Company's books as a deferred tax asset or deferred tax liability until such time as they reverse.

Realization of the Company's deferred tax assets is primarily dependent upon the Company generating sufficient future taxable income to obtain benefit from the reversal of net deductible temporary differences and utilization of tax credit carryforwards and the net operating loss carryforwards for Federal and California state income tax purposes. The amount of deferred tax assets considered realizable is subject to adjustment in future periods based on estimates of future taxable income. Under generally accepted accounting principles a valuation allowance is required to be recognized if it is "more likely than not" that a deferred tax asset will not be realized. The determination of the realizability of the deferred tax assets is highly subjective and dependent upon judgment concerning management's evaluation of both positive and negative evidence, including forecasts of future income, cumulative losses, applicable tax planning strategies, and assessments of current and future economic and business conditions.

The Company had net deferred tax assets of \$23.3 million and \$19.3 million at December 31, 2013, and December 31, 2012, respectively. After consideration of the matters in the preceding paragraph, the Company determined that it is more likely than not that the net deferred tax asset at December 31, 2013 and December 31, 2012 will be fully realized in future years.

**Financial Condition**

As of December 31, 2013, total assets were \$1.49 billion, a decrease of 12% compared to \$1.69 billion at December 31, 2012. Excluding the Company's excess funds held at the Federal Reserve Bank offsetting the short-term deposits of \$46.5 million at December 31, 2013, and \$271.9 million at December 31, 2012, total assets at December 31, 2013 increased 2% from December 31, 2012. The investment securities available-for-sale portfolio totaled \$280.1 million at December 31, 2013, a decrease of 24% from \$367.9 million at December 31, 2012. In addition, securities held-to-maturity totaled \$95.9 million at December 31, 2013, compared to \$51.5 million at December 31, 2012. The total loan portfolio, excluding loans held-for-sale, was \$914.9 million, an increase of 13% from \$812.3 million at year-end 2012.

Total deposits were \$1.29 billion at December 31, 2013, a decrease of 13% from \$1.48 billion at year-end 2012. Deposits (excluding all time deposits, CDARS deposits, and short-term deposits from one customer of \$19.0 million at December 31, 2013 and \$271.9 million at December 31, 2012) increased \$70.8 million, or 8%, to \$954.6 million at December 31, 2013, from \$883.8 million at December 31, 2012. There was no subordinated debt at December 31, 2013, compared to \$9.3 million at December 31, 2012, as a result of the redemption of \$9.0 million fixed-rate subordinated debt during the third quarter of 2013.

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**Securities Portfolio**

The following table reflects the balances for each category of securities at year-end:

**Investment Portfolio**

|  | December 31,      |                   |                   |
|--|-------------------|-------------------|-------------------|
|  | 2013              | 2012              | 2011              |
| (Dollars in thousands)                         |                   |                   |                   |
| Securities available-for-sale (at fair value): |                   |                   |                   |
| Agency mortgage-backed securities              | \$ 207,644        | \$ 291,244        | \$ 350,348        |
| Corporate bonds                                | 52,046            | 55,588            |                   |
| Trust preferred securities                     | 20,410            | 21,080            | 30,107            |
| <b>Total</b>                                   | <b>\$ 280,100</b> | <b>\$ 367,912</b> | <b>\$ 380,455</b> |

Securities held-to-maturity (at amortized cost):

|                                   |                  |                  |           |
|-----------------------------------|------------------|------------------|-----------|
| Agency mortgage-backed securities | \$ 15,932        | \$ 16,659        | \$        |
| Municipals Tax Exempt             | 79,989           | 34,813           |           |
|                                   | <b>\$ 95,921</b> | <b>\$ 51,472</b> | <b>\$</b> |

The table below summarizes the weighted average life and weighted average yields of securities as of December 31, 2013:

|  | December 31, 2013<br>Weighted Average Life |              |                                       |              |                    |              |                   |              |
|--|--|--------------|---------------------------------------|--------------|--------------------|--------------|-------------------|--------------|
|  | After One<br>and Within<br>Five Years      |              | After Five<br>and Within<br>Ten Years |              | After<br>Ten Years |              | Total             |              |
|  | Amount                                     | Yield        | Amount                                | Yield        | Amount             | Yield        | Amount            | Yield        |
| (Dollars in thousands)                           |  |              |                                       |              |                    |              |                   |              |
| Securities available-for-sale (at fair value):   |  |              |                                       |              |                    |              |                   |              |
| Agency mortgage-backed securities                | \$ 84,744                                  | 2.82%        | \$ 122,900                            | 2.80%        | \$                 |              | \$ 207,644        | 2.81%        |
| Corporate bonds                                  | 6,618                                      | 2.79%        | 45,428                                | 3.08%        |                    |              | 52,046            | 3.05%        |
| Trust preferred securities                       |  |              |                                       |              | 20,410             | 4.87%        | 20,410            | 4.87%        |
|  | <b>\$ 91,362</b>                           | <b>2.82%</b> | <b>\$ 168,328</b>                     | <b>2.88%</b> | <b>\$ 20,410</b>   | <b>4.87%</b> | <b>\$ 280,100</b> | <b>3.00%</b> |
| Securities held-to-maturity (at amortized cost): |  |              |                                       |              |                    |              |                   |              |
| Agency mortgage-backed securities                | \$ 6,634                                   | 2.54%        | \$                                    | 0.00%        | \$ 9,298           | 3.60%        | \$ 15,932         | 3.16%        |
| Municipals Tax Exempt(1)                         | 1,229                                      | 4.36%        | 12,842                                | 4.25%        | 65,918             | 3.84%        | 79,989            | 3.91%        |
|  | <b>\$ 7,863</b>                            | <b>2.83%</b> | <b>\$ 12,842</b>                      | <b>4.25%</b> | <b>\$ 75,216</b>   | <b>3.81%</b> | <b>\$ 95,921</b>  | <b>3.79%</b> |

- 
- (1) Reflects tax equivalent yield based on a 35% tax rate.

The securities portfolio is the second largest component of the Company's interest-earning assets, and the structure and composition of this portfolio is important to an analysis of the financial condition of the Company. The portfolio serves the following purposes: (i) it provides a source of pledged assets for securing certain deposits and borrowed funds, as may be required by law or by specific agreement with a depositor or lender; (ii) it provides liquidity to even out cash flows from the loan and deposit activities of customers; (iii) it can be used as an interest rate risk management tool, since it provides a large base of assets, the maturity and interest rate characteristics of which can be changed more readily than the loan portfolio to better match changes in the deposit base and other funding sources of the Company; and (iv) it is an alternative interest-earning use of funds when loan demand is weak or when deposits grow more rapidly than loans.



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The Company's portfolio may include: (i) U.S. Treasury securities and U.S. Government sponsored entities' debt securities for liquidity and pledging; (ii) mortgage-backed securities, which in many instances can also be used for pledging, and which generally enhance the yield of the portfolio; (iii) municipal obligations, which provide tax free income and limited pledging potential; (iv) collateralized mortgage obligations, which generally enhance the yield of the portfolio; and (v) single entity issue trust preferred securities, which generally enhance the yield on the portfolio.

The Company classifies its securities as either available-for-sale or held-to-maturity at the time of purchase. Prior to the third quarter of 2012, the Company's securities were all classified under existing accounting rules as "available-for-sale" to allow flexibility for the management of the portfolio. During the third quarter of 2012, the Company evaluated its available-for-sale portfolio and reclassified at fair value approximately \$16.4 million of the mortgage-backed securities with higher price volatility and longer maturities to the held-to-maturity category. The related unrealized after-tax gains of \$465,000 at December 31, 2013, remained in accumulated other comprehensive income and will be amortized over the remaining life of the securities as an adjustment to yield, offsetting the related amortization of the premium or accretion of the discount on the transferred securities. No gains or losses were recognized at the time of reclassification. Management considers the held-to-maturity classification of these investment securities to be appropriate based on the Company's positive intent and ability to hold these securities to maturity. The increase in the investment securities held-to-maturity portfolio at December 31, 2013, from December 31, 2012, was primarily due to purchases of higher yielding municipal bonds with favorable tax benefits, which the Company intends to hold until maturity. Accounting guidance requires available-for-sale securities to be marked to fair value with an offset to accumulated other comprehensive income (loss), a component of shareholders' equity. Monthly adjustments are made to reflect changes in the fair value of the Company's available-for-sale securities.

The investment securities available-for-sale portfolio totaled \$280.1 million at December 31, 2013, a decrease of 24% from \$367.9 million at December 31, 2012. At December 31, 2013, the securities available-for-sale portfolio was comprised of \$207.6 million agency mortgage-backed securities (all issued by U.S. Government sponsored entities), \$52.1 million of corporate bonds, and \$20.4 million of single entity issue trust preferred securities.

The investment securities held-to-maturity portfolio, at amortized cost, totaled \$95.9 million at December 31, 2013, compared to \$51.5 million at December 31, 2012. At December 31, 2013, the investment securities held-to-maturity portfolio was comprised of \$80.0 million of tax-exempt municipal bonds, and \$15.9 million of agency mortgage-backed securities.

The Company has not used interest rate swaps or other derivative instruments to hedge fixed rate loans or securities to otherwise mitigate interest rate risk.

***Loans***

The Company's loans represent the largest portion of earning assets, substantially greater than the securities portfolio or any other asset category, and the quality and diversification of the loan portfolio is an important consideration when reviewing the Company's financial condition.

Gross loans, excluding loans held-for-sale, represented 61% of total assets at December 31, 2013, as compared to 48% of total assets at December 31, 2012 (63% and 57% of total assets, excluding the excess funds held at the Federal Reserve Bank offsetting the short-term deposits of \$46.5 million and \$271.9 million at the respective year-end periods). The ratio of loans to deposits increased to 71.13% at December 31, 2013 from 54.91% December 31, 2012. Excluding the short-term deposits, the loan to deposit ratio was 73.80% at December 31, 2013, and 67.27% at December 31, 2012.

The Loan Distribution table that follows sets forth the Company's gross loans outstanding, excluding loans held-for-sale, and the percentage distribution in each category at the dates indicated.

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**Loan Distribution**

|   | 2013              |               | 2012              |               | December 31,<br>2011 |               | 2010              |               | 2009                |               |
|---|-------------------|---------------|-------------------|---------------|----------------------|---------------|-------------------|---------------|---------------------|---------------|
|   | \$                | % to<br>Total | \$                | % to<br>Total | \$                   | % to<br>Total | \$                | % to<br>Total | \$                  | % to<br>Total |
| (Dollars in thousands)                          |                   |               |                   |               |                      |               |                   |               |                     |               |
| Commercial                                      | \$ 393,074        | 43%           | \$ 375,469        | 46%           | \$ 366,590           | 48%           | \$ 378,412        | 45%           | \$ 427,177          | 40%           |
| Real estate:                                    |                   |               |                   |               |                      |               |                   |               |                     |               |
| Commercial and residential                      | 423,288           | 46%           | 354,934           | 44%           | 311,479              | 41%           | 337,457           | 40%           | 400,731             | 37%           |
| Land and construction                           | 31,443            | 3%            | 22,352            | 3%            | 23,016               | 3%            | 62,356            | 7%            | 182,871             | 17%           |
| Home equity                                     | 51,815            | 6%            | 43,865            | 5%            | 52,017               | 7%            | 53,697            | 6%            | 51,368              | 5%            |
| Consumer  | 15,677            | 2%            | 15,714            | 2%            | 11,166               | 1%            | 13,244            | 2%            | 7,181               | 1%            |
| <b>Loans</b>                                    | <b>915,297</b>    | <b>100%</b>   | <b>812,334</b>    | <b>100%</b>   | <b>764,268</b>       | <b>100%</b>   | <b>845,166</b>    | <b>100%</b>   | <b>1,069,328</b>    | <b>100%</b>   |
| Deferred loan (fees) costs, net                 | (384)             |               | (21)              |               | 323                  |               | 883               |               | 785                 |               |
| <b>Loans, including deferred fees and costs</b> | <b>914,913</b>    | <b>100%</b>   | <b>812,313</b>    | <b>100%</b>   | <b>764,591</b>       | <b>100%</b>   | <b>846,049</b>    | <b>100%</b>   | <b>1,070,113</b>    | <b>100%</b>   |
| Allowance for loan losses                       | (19,164)          |               | (19,027)          |               | (20,700)             |               | (25,204)          |               | (28,768)            |               |
| <b>Loans, net</b>                               | <b>\$ 895,749</b> |               | <b>\$ 793,286</b> |               | <b>\$ 743,891</b>    |               | <b>\$ 820,845</b> |               | <b>\$ 1,041,345</b> |               |

The Company's loan portfolio is concentrated in commercial (primarily manufacturing, wholesale, and services oriented entities) and commercial real estate, with the balance in land development and construction and home equity and consumer loans. The Company does not have any concentrations by industry or group of industries in its loan portfolio, however, 55% of its gross loans were secured by real property as of December 31, 2013, compared to 52% as of December 31, 2012. While no specific industry concentration is considered significant, the Company's lending operations are located in areas that are dependent on the technology and real estate industries and their supporting companies.

The Company has established concentration limits in its loan portfolio for commercial real estate loans, commercial loans, construction loans and unsecured lending, among others. All loan types are within established limits. The Company uses underwriting guidelines to assess the borrowers' historical cash flow to determine debt service, and we further stress test the debt service under higher interest rate scenarios. Financial and performance covenants are used in commercial lending to allow the Company to react to a borrower's deteriorating financial condition, should that occur.

The Company's commercial loans are made for working capital, financing the purchase of equipment or for other business purposes. Commercial loans include loans with maturities ranging from thirty days to one year and "term loans" with maturities normally ranging from one to five years. Short-term business loans are generally intended to finance current transactions and typically provide for periodic principal payments, with interest payable monthly. Term loans normally provide for floating interest rates, with monthly payments of both principal and interest.

The Company is an active participant in the SBA and U.S. Department of Agriculture guaranteed lending programs, and has been approved by the SBA as a lender under the Preferred Lender Program. The Company regularly makes such loans conditionally guaranteed by the SBA (collectively referred to as "SBA loans"). The guaranteed portion of these loans is typically sold in the secondary market depending on market conditions. When the guaranteed portion of an SBA loan is sold the Company retains the servicing rights for the sold portion. During 2013,

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loans were sold resulting in a gain on sales of SBA loans of \$449,000, compared to a gain on sales of SBA loans of \$702,000 for 2012, and \$1.5 million for 2011.

As of December 31, 2013, commercial and residential real estate loans of \$423.3 million consist primarily of adjustable and fixed-rate loans secured by deeds of trust on commercial and residential property. The commercial and residential real estate loans at December 31, 2013 consist of \$203.4 million, or 48% of commercial owner occupied properties, \$219.4 million, or 52%, of commercial investment properties, and \$480,000, or less than 1%, of residential properties. Properties securing the commercial

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and residential real estate loans are primarily located in the Company's primary market, which is the Greater San Francisco Bay Area.

The Company's commercial real estate loans consist primarily of loans based on the borrower's cash flow and are secured by deeds of trust on commercial and residential property to provide a secondary source of repayment. The Company generally restricts real estate term loans to no more than 75% of the property's appraised value or the purchase price of the property during the initial underwriting of the credit, depending on the type of property and its utilization. The Company offers both fixed and floating rate loans. Maturities on real estate mortgage loans are generally between five and ten years (with amortization ranging from fifteen to twenty-five years and a balloon payment due at maturity and amortization of thirty years on loans secured by apartments); however, SBA and certain other real estate loans that can be sold in the secondary market may be granted for longer maturities.

The Company's land and construction loans are primarily to finance the development/construction of commercial and single family residential properties. The Company utilizes underwriting guidelines to assess the likelihood of repayment from sources such as sale of the property or availability of permanent mortgage financing prior to making the construction loan. Construction loans are provided only in our market area, and we have extensive controls for the disbursement process. The projects are typically infill construction in strong markets. Land and construction loans increased \$9.0 million to \$31.4 million at December 31, 2013, from \$22.4 million at December 31, 2012. The level of our construction lending is significantly lower than it was five years ago.

The Company makes home equity lines of credit available to its existing customers. Home equity lines of credit are underwritten initially with a maximum 75% loan to value ratio. Home equity lines are reviewed quarterly, with specific emphasis on loans with a loan to value ratio greater than 70% and loans that were underwritten from mid-2005 through 2008, when real estate values were at the peak in the cycle. The Company takes measures to work with customers to reduce line commitments and minimize potential losses.

Additionally, the Company makes consumer loans for the purpose of financing automobiles, various types of consumer goods, and other personal purposes. Consumer loans generally provide for the monthly payment of principal and interest. Most of the Company's consumer loans are secured by the personal property being purchased or, in the instances of home equity loans or lines, real property.

With certain exceptions, state chartered banks are permitted to make extensions of credit to any one borrowing entity up to 15% of the bank's capital and reserves for unsecured loans and up to 25% of the bank's capital and reserves for secured loans. For HBC, these lending limits were \$26.3 million and \$43.8 million at December 31, 2013, respectively.

***Loan Maturities***

The following table presents the maturity distribution of the Company's loans as of December 31, 2013. The table shows the distribution of such loans between those loans with predetermined (fixed) interest rates and those with variable (floating) interest rates. Floating rates generally fluctuate with changes in the prime rate as reflected in the Western Edition of The Wall Street Journal. As of December 31, 2013, approximately 59% of the Company's loan portfolio consisted of floating interest rate loans.

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|                            | <b>Due in<br/>One Year<br/>or Less</b> | <b>Over One<br/>Year But<br/>Less than<br/>Five Years</b> | <b>Over<br/>Five Years</b> | <b>Total</b>      |
|----------------------------|--|---|----------------------------|-------------------|
|                            | <b>(Dollars in thousands)</b>          |   |                            |                   |
| Commercial                 | \$ 286,916                             | \$ 40,088   | \$ 66,070                  | \$ 393,074        |
| Real estate:               |  |   |                            |                   |
| Commercial and residential | 82,186                                 | 191,659   | 149,443                    | 423,288           |
| Land and construction      | 30,943                                 | 500   |                            | 31,443            |
| Home equity                | 49,166                                 | 1,344   | 1,305                      | 51,815            |
| Consumer                   | 15,259                                 | 340   | 78                         | 15,677            |
| <b>Loans</b>               | <b>\$ 464,470</b>                      | <b>\$ 233,931</b>   | <b>\$ 216,896</b>          | <b>\$ 915,297</b> |

|                                    |            |           |           |            |
|------------------------------------|------------|-----------|-----------|------------|
| Loans with variable interest rates | \$ 413,703 | \$ 60,447 | \$ 68,828 | \$ 542,978 |
| Loans with fixed interest rates    | 50,767     | 173,484   | 148,068   | 372,319    |

|       |            |            |            |            |
|-------|------------|------------|------------|------------|
| Loans | \$ 464,470 | \$ 233,931 | \$ 216,896 | \$ 915,297 |
|-------|------------|------------|------------|------------|

***Loan Servicing***

As of December 31, 2013, 2012, and 2011 there were \$135.5 million, \$150.2 million, and \$171.0 million, respectively, in SBA loans that were serviced by the Company for others. Activity for loan servicing rights was as follows:

|                           | <b>2013</b>                   | <b>2012</b> | <b>2011</b> |
|---------------------------|-------------------------------|-------------|-------------|
|                           | <b>(Dollars in thousands)</b> |             |             |
| Beginning of year balance | \$ 709                        | \$ 792      | \$ 915      |
| Additions                 | 106                           | 184         | 294         |
| Amortization              | (290)                         | (267)       | (417)       |
| End of year balance       | \$ 525                        | \$ 709      | \$ 792      |

Loan servicing rights are included in Accrued Interest Receivable and Other Assets on the consolidated balance sheets and reported net of amortization. There was no valuation allowance as of December 31, 2013 and 2012, as the fair market value of the assets was greater than the carrying value.

I/O strip receivables relate to the excess servicing assets on loans sold prior to 2009. Activity for the I/O strip receivable was as follows:

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|                                | 2013                   | 2012     | 2011     |
|--------------------------------|------------------------|----------|----------|
|                                | (Dollars in thousands) |          |          |
| Beginning of year balance      | \$ 1,786               | \$ 2,094 | \$ 2,140 |
| Amortization                   |                        |          | (96)     |
| Unrealized holding gain (loss) | (139)                  | (308)    | 50       |
| End of year balance            | \$ 1,647               | \$ 1,786 | \$ 2,094 |

*Credit Quality*

Financial institutions generally have a certain level of exposure to credit quality risk, and could potentially receive less than a full return of principal and interest if a debtor becomes unable or unwilling to repay. Since loans are the most significant assets of the Company and generate the largest portion of its revenues, the Company's management of credit quality risk is focused primarily on loan quality. Banks

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have generally suffered their most severe earnings declines as a result of customers' inability to generate sufficient cash flow to service their debts and/or downturns in national and regional economies and declines in overall asset values including real estate. In addition, certain debt securities that the Company may purchase have the potential of declining in value if the obligor's financial capacity to repay deteriorates.

The Company's policies and procedures identify market segments, set goals for portfolio growth or contraction, and establish limits on industry and geographic credit concentrations. In addition, these policies establish the Company's underwriting standards and the methods of monitoring ongoing credit quality. The Company's internal credit risk controls are centered in underwriting practices, credit granting procedures, training, risk management techniques, and familiarity with loan customers as well as the relative diversity and geographic concentration of our loan portfolio.

The Company's credit risk may also be affected by external factors such as the level of interest rates, employment, general economic conditions, real estate values, and trends in particular industries or geographic markets. As an independent community bank serving a specific geographic area, the Company must contend with the unpredictable changes in the general California market and, particularly, primary local markets. The Company's asset quality has suffered in the past from the impact of national and regional economic recessions, consumer bankruptcies, and depressed real estate values.

Nonperforming assets are comprised of the following: loans and loans held-for-sale for which the Company is no longer accruing interest; restructured loans which have been current under six months; loans 90 days or more past due and still accruing interest (although they are generally placed on nonaccrual when they become 90 days past due, unless they are both well-secured and in the process of collection); and foreclosed assets. Management's classification of a loan as "nonaccrual" is an indication that there is reasonable doubt as to the full recovery of principal or interest on the loan. At that point, the Company stops accruing interest income, and reverses any uncollected interest that had been accrued as income. The Company begins recognizing interest income only as cash interest payments are received and it has been determined the collection of all outstanding principal is not in doubt. The loans may or may not be collateralized, and collection efforts are pursued. Loans may be restructured by management when a borrower has experienced some change in financial status causing an inability to meet the original repayment terms and where the Company believes the borrower will eventually overcome those circumstances and make full restitution. Foreclosed assets consist of properties and other assets acquired by foreclosure or similar means that management is offering or will offer for sale.

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The following table summarizes the Company's nonperforming assets at the dates indicated:

**Nonperforming Assets**

|  | December 31, |           |           |           |           |
|--|--------------|-----------|-----------|-----------|-----------|
|  | 2013         | 2012      | 2011      | 2010      | 2009      |
| (Dollars in thousands)                                     |              |           |           |           |           |
| Nonaccrual loans held-for-sale                             | \$           | \$        | \$ 186    | \$ 2,026  | \$        |
| Nonaccrual loans held-for-investment                       | 11,326       | 17,335    | 14,353    | 28,821    | 59,480    |
| Restructured and loans 90 days past due and still accruing | 492          | 859       | 2,291     | 2,256     | 2,895     |
| <br>   |              |           |           |           |           |
| Total nonperforming loans                                  | 11,818       | 18,194    | 16,830    | 33,103    | 62,375    |
| Foreclosed assets  | 575          | 1,270     | 2,312     | 1,296     | 2,241     |
| <br>   |              |           |           |           |           |
| Total nonperforming assets                                 | \$ 12,393    | \$ 19,464 | \$ 19,142 | \$ 34,399 | \$ 64,616 |

|  |       |       |       |       |       |
|--|-------|-------|-------|-------|-------|
| Nonperforming assets as a percentage of loans plus nonaccrual loans held-for-sale plus foreclosed assets | 1.35% | 2.39% | 2.50% | 4.05% | 6.03% |
| Nonperforming assets as a percentage of total assets   | 0.83% | 1.15% | 1.47% | 2.76% | 4.74% |

The following table presents nonperforming loans by class at year end:

|                            | 2013       |   |           | 2012       |   |           |
|----------------------------|------------|---|-----------|------------|---|-----------|
|                            | Nonaccrual | Restructured and Loans Over 90 Days Past Due and Still Accruing | Total     | Nonaccrual | Restructured and Loans Over 90 Days Past Due and Still Accruing | Total     |
| (Dollars in thousands)     |            |   |           |            |   |           |
| Commercial                 | \$ 4,414   | \$ 492  | \$ 4,906  | \$ 7,852   | \$ 859  | \$ 8,711  |
| Real estate:               |            |   |           |            |   |           |
| Commercial and residential | 4,363      |   | 4,363     | 4,676      |   | 4,676     |
| Land and construction      | 1,761      |   | 1,761     | 2,223      |   | 2,223     |
| Home equity                | 666        |   | 666       | 2,437      |   | 2,437     |
| Consumer                   | 122        |   | 122       | 147        |   | 147       |
| <br>                       |            |   |           |            |   |           |
| Total                      | \$ 11,326  | \$ 492  | \$ 11,818 | \$ 17,335  | \$ 859  | \$ 18,194 |

Nonperforming assets were \$12.4 million, or 0.83% of total assets, at December 31, 2013, compared to \$19.5 million, or 1.15% of total assets, at December 31, 2012. Excluding the Company's excess funds held at the Federal Reserve Bank offsetting the short-term deposits of \$46.5 million at December 31, 2013, and \$271.9 million at December 31, 2012, nonperforming assets to total assets were 0.86% and 1.37% at the respective year-end periods. Included in total nonperforming assets were foreclosed assets of \$575,000 at December 31, 2013, compared to \$1.3 million at December 31, 2012. The decline in nonperforming assets at December 31, 2013 was primarily due to loan payoffs, charge-offs, and upgrades in nonperforming loans' risk categories.





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The following table provides a summary of the loan portfolio by loan type and credit quality classification at the dates indicated:

|                            | December 31, 2013      |                  |                   | December 31, 2012 |                  |                   |
|----------------------------|------------------------|------------------|-------------------|-------------------|------------------|-------------------|
|                            | Nonclassified          | Classified       | Total             | Nonclassified     | Classified       | Total             |
|                            | (Dollars in thousands) |                  |                   |                   |                  |                   |
| Commercial                 | \$ 380,806             | \$ 12,268        | \$ 393,074        | \$ 355,440        | \$ 20,029        | \$ 375,469        |
| Real estate:               |                        |                  |                   |                   |                  |                   |
| Commercial and residential | 416,992                | 6,296            | 423,288           | 345,045           | 9,889            | 354,934           |
| Land and construction      | 29,682                 | 1,761            | 31,443            | 18,858            | 3,494            | 22,352            |
| Home equity                | 48,818                 | 2,997            | 51,815            | 41,187            | 2,678            | 43,865            |
| Consumer                   | 15,336                 | 341              | 15,677            | 15,321            | 393              | 15,714            |
| <b>Total</b>               | <b>\$ 891,634</b>      | <b>\$ 23,663</b> | <b>\$ 915,297</b> | <b>\$ 775,851</b> | <b>\$ 36,483</b> | <b>\$ 812,334</b> |

Classified loans in the table above are gross of SBA guarantees.

The following provides a rollforward of troubled debt restructurings ("TDRs"):

|                                     | For the Year Ended December 31, 2013 |                    |                 |
|-------------------------------------|--------------------------------------|--------------------|-----------------|
|                                     | Performing TDRs                      | Nonperforming TDRs | Total           |
|                                     | (Dollars in thousands)               |                    |                 |
| Balance at January 1, 2013          | \$ 2,309                             | \$ 1,798           | \$ 4,107        |
| Principal repayments                | (1,630)                              | (125)              | (1,755)         |
| Net charge-offs                     |                                      | (372)              | (372)           |
| Change in TDR classification        | (187)                                | 187                |                 |
| New modifications                   |                                      | 1,742              | 1,742           |
| <b>Balance at December 31, 2013</b> | <b>\$ 492</b>                        | <b>\$ 3,230</b>    | <b>\$ 3,722</b> |

|                                     | For the Year Ended December 31, 2012 |                    |                 |
|-------------------------------------|--------------------------------------|--------------------|-----------------|
|                                     | Performing TDRs                      | Nonperforming TDRs | Total           |
|                                     | (Dollars in thousands)               |                    |                 |
| Balance at January 1, 2012          | \$ 3,073                             | \$ 4,323           | \$ 7,396        |
| Principal repayments                | (1,014)                              | (2,338)            | (3,352)         |
| Net charge-offs                     | (131)                                |                    | (131)           |
| Change in TDR classification        | 294                                  | (294)              |                 |
| New modifications                   | 87                                   | 107                | 194             |
| <b>Balance at December 31, 2012</b> | <b>\$ 2,309</b>                      | <b>\$ 1,798</b>    | <b>\$ 4,107</b> |

*Allowance for Loan Losses*

The allowance for loan losses is an estimate of probable incurred losses in the loan portfolio. Loans are charged-off against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance for loan losses. Management's methodology for estimating the allowance balance consists of several key elements, which include specific allowances on individual impaired loans and the formula driven allowances on pools of loans with similar risk characteristics. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that in management's judgment should be charged off.

Specific allowances are established for impaired loans. Management considers a loan to be impaired when it is probable that the Company will be unable to collect all amounts due according to the original

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contractual terms of the loan agreement, including scheduled interest payments. Loans for which the terms have been modified with a concession granted, and for which the borrower is experiencing financial difficulties, are considered troubled debt restructurings and classified as impaired. When a loan is considered to be impaired, the amount of impairment is measured based on the fair value of the collateral, less costs to sell, if the loan is collateral dependent or on the present value of expected future cash flows or values that are observable in the secondary market. If the measure of the impaired loans is less than the investment in the loan, the deficiency will be charged off against the allowance for loan losses if the amount is a confirmed loss, or, alternatively, a specific allocation within the allowance will be established. Loans that are considered impaired are specifically excluded from the formula portion of the allowance for loan loss analysis.

The estimated loss factors for pools of loans that are not impaired are based on determining the probability of default and loss given default for loans within each segment of the portfolio, adjusted for significant factors that, in management's judgment, affect collectibility as of the evaluation date. The Company's historical delinquency experience and loss experience are utilized to determine the probability of default and loss given default for segments of the portfolio where the Company has experienced losses in the past. For segments of the portfolio where the Company has no significant prior loss experience, the Company uses quantifiable observable industry data to determine the probability of default and loss given default.

Loans that demonstrate a weakness for which there is a possibility of loss if the weakness is not corrected are categorized as "classified." Classified assets include all loans considered as substandard, substandard-nonaccrual, and doubtful and may result from problems specific to a borrower's business or from economic downturns that affect the borrower's ability to repay or that cause a decline in the value of the underlying collateral (particularly real estate), and foreclosed assets. The principal balance of classified assets, net of SBA guarantees, was \$23.6 million at December 31, 2013, \$36.8 million at December 31, 2012, and \$59.5 million at December 31, 2011. There were no loans held-for-sale included in classified assets at December 31, 2013 and December 31, 2012. Included in classified assets at December 31, 2011 were \$413,000 of loans held-for-sale. Loans held-for-sale are carried at the lower of cost or estimated fair value, and are not allocated an allowance for loan losses.

It is the policy of management to maintain the allowance for loan losses at a level adequate for risks inherent in the loan portfolio. On an ongoing basis, we have engaged an outside firm to perform independent credit reviews of our loan portfolio. The Federal Reserve Bank of San Francisco and the California Department of Financial Institutions also review the allowance for loan losses as an integral part of the examination process. Based on information currently available, management believes that the allowance for loan losses is adequate. However, the loan portfolio can be adversely affected if California economic conditions and the real estate market in the Company's market area were to weaken. Also, any weakness of a prolonged nature in the technology industry would have a negative impact on the local market. The effect of such events, although uncertain at this time, could result in an increase in the level of nonperforming loans and increased loan losses, which could adversely affect the Company's future growth and profitability. No assurance of the ultimate level of credit losses can be given with any certainty.

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The following table summarizes the Company's loan loss experience, as well as provisions and charges to the allowance for loan losses and certain pertinent ratios for the periods indicated:

#### **Allowance for Loan Losses**

|   | 2013                   | 2012           | 2011            | 2010            | 2009            |
|---|------------------------|----------------|-----------------|-----------------|-----------------|
|   | (Dollars in thousands) |                |                 |                 |                 |
| Balance, beginning of year                | \$ 19,027              | \$ 20,700      | \$ 25,204       | \$ 28,768       | \$ 25,007       |
| Charge-offs:                              |                        |                |                 |                 |                 |
| Commercial                                | (1,676)                | (3,935)        | (7,559)         | (7,098)         | (16,512)        |
| Real estate:                              |                        |                |                 |                 |                 |
| Commercial and residential                | (173)                  | (1,362)        | (1,599)         | (6,763)         | (1,610)         |
| Land and construction                     | (1)                    | (133)          | (1,757)         | (17,927)        | (12,588)        |
| Home equity                               | (102)                  | (33)           |                 | (25)            | (764)           |
| Consumer                                  |                        |                | (8)             | (354)           | (60)            |
| <b>Total charge-offs</b>                  | <b>(1,952)</b>         | <b>(5,463)</b> | <b>(10,923)</b> | <b>(32,167)</b> | <b>(31,534)</b> |
| Recoveries:                               |                        |                |                 |                 |                 |
| Commercial                                | 2,621                  | 776            | 678             | 837             | 1,187           |
| Real estate:                              |                        |                |                 |                 |                 |
| Commercial and residential                | 274                    | 230            | 381             | 5               | 10              |
| Land and construction                     |                        |                | 879             | 921             | 170             |
| Home equity                               | 9                      |                | 9               | 36              |                 |
| Consumer                                  | 1                      |                | 3               |                 |                 |
| <b>Total recoveries</b>                   | <b>2,905</b>           | <b>1,006</b>   | <b>1,950</b>    | <b>1,799</b>    | <b>1,367</b>    |
| <b>Net recoveries (charge-offs)</b>       | <b>953</b>             | <b>(4,457)</b> | <b>(8,973)</b>  | <b>(30,368)</b> | <b>(30,167)</b> |
| <b>Provision (credit) for loan losses</b> | <b>(816)</b>           | <b>2,784</b>   | <b>4,469</b>    | <b>26,804</b>   | <b>33,928</b>   |
| <br>                                      |                        |                |                 |                 |                 |
| Balance, end of year                      | \$ 19,164              | \$ 19,027      | \$ 20,700       | \$ 25,204       | \$ 28,768       |

#### **RATIOS:**

|  |         |         |         |        |        |
|--|---------|---------|---------|--------|--------|
| Net (recoveries) charge-offs to average loans*   | -0.11%  | 0.57%   | 1.12%   | 3.18%  | 2.59%  |
| Allowance for loan losses to total loans*  | 2.09%   | 2.34%   | 2.71%   | 2.98%  | 2.69%  |
| Allowance for loan losses to nonperforming loans, excluding nonaccrual loans held-for-sale | 162.16% | 104.58% | 124.37% | 81.10% | 46.12% |

\*

Excludes loans held-for-sale

The following table provides a summary of the allocation of the allowance for loan losses for specific categories at the dates indicated. The allocation presented should not be interpreted as an indication that charges to the allowance for loan losses will be incurred in these amounts or proportions, or that the portion of the allowance allocated to each category represents the total amount available for charge-offs that may occur within these categories.



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|                            | December 31,           |             |                  |             |                  |             |                  |             |                  |             |
|----------------------------|------------------------|-------------|------------------|-------------|------------------|-------------|------------------|-------------|------------------|-------------|
|                            | 2013                   |             | 2012             |             | 2011             |             | 2010             |             | 2009             |             |
|                            | Percent                | Percent     | Percent          | Percent     | Percent          | Percent     | Percent          | Percent     | Percent          | Percent     |
|                            | of                     | of          | of               | of          | of               | of          | of               | of          | of               | of          |
|                            | Loans                  | Loans       | Loans            | Loans       | Loans            | Loans       | Loans            | Loans       | Loans            | Loans       |
|                            | in                     | in          | in               | in          | in               | in          | in               | in          | in               | in          |
|                            | each                   | each        | each             | each        | each             | each        | each             | each        | each             | each        |
|                            | category               | category    | category         | category    | category         | category    | category         | category    | category         | category    |
|                            | to                     | to          | to               | to          | to               | to          | to               | to          | to               | to          |
|                            | total                  | total       | total            | total       | total            | total       | total            | total       | total            | total       |
|                            | Allowance              | Allowance   | Allowance        | Allowance   | Allowance        | Allowance   | Allowance        | Allowance   | Allowance        | Allowance   |
|                            | loans                  | loans       | loans            | loans       | loans            | loans       | loans            | loans       | loans            | loans       |
|                            | (Dollars in thousands) |             |                  |             |                  |             |                  |             |                  |             |
| Commercial                 | \$ 12,533              | 43%         | \$ 12,866        | 46%         | \$ 13,215        | 48%         | \$ 13,952        | 45%         | \$ 12,687        | 40%         |
| Real estate:               |                        |             |                  |             |                  |             |                  |             |                  |             |
| Commercial and residential | 4,922                  | 46%         | 4,609            | 44%         | 6,203            | 41%         | 5,500            | 40%         | 3,467            | 37%         |
| Land and construction      | 356                    | 3%          | 399              | 3%          | 594              | 3%          | 4,271            | 7%          | 11,492           | 17%         |
| Home equity                | 1,270                  | 6%          | 1,026            | 5%          | 541              | 7%          | 592              | 6%          | 993              | 5%          |
| Consumer                   | 83                     | 2%          | 127              | 2%          | 147              | 1%          | 889              | 2%          | 129              | 1%          |
| <b>Total</b>               | <b>\$ 19,164</b>       | <b>100%</b> | <b>\$ 19,027</b> | <b>100%</b> | <b>\$ 20,700</b> | <b>100%</b> | <b>\$ 25,204</b> | <b>100%</b> | <b>\$ 28,768</b> | <b>100%</b> |

The allowance for loan losses totaled \$19.2 million, or 2.09% of total loans at December 31, 2013, compared to \$19.0 million, or 2.34% of total loans at December 31, 2012. Loan charge-offs reflect the realization of losses in the portfolio that were partially recognized previously through the provision for loan losses. The Company had net recoveries of \$953,000, or 0.11% of average loans, for the year ended December 31, 2013, compared to net charge-offs of \$4.5 million, or 0.57% of average loans, for the year ended December 31, 2012. The allowance for loan losses related to the commercial portfolio decreased \$333,000 at December 31, 2013 from December 31, 2012, as a result of a credit to the provision for loan losses of \$1.3 million and net recoveries of \$945,000. The decrease in the allowance for loan losses was primarily due to a decline in problem loans and historical charge off levels. The allowance for loan losses related to the real estate portfolio increased \$514,000 at December 31, 2013 from December 31, 2012, as a result of a provision for loan losses of \$507,000 and net recoveries of \$7,000. The increase in the allowance for loan losses was primarily due to an increase in the balance of real estate loans outstanding, partially offset by a decline in problem loans and historical charge off levels.

**Deposits**

The composition and cost of the Company's deposit base are important components in analyzing the Company's net interest margin and balance sheet liquidity characteristics, both of which are discussed in greater detail in other sections in this report. The Company's liquidity is impacted by the volatility of deposits or other funding instruments or, in other words, by the propensity of that money to leave the institution for rate-related or other reasons. Deposits can be adversely affected if economic conditions in California, and the Company's market area in particular, weaken. Potentially, the most volatile deposits in a financial institution are jumbo certificates of deposit, meaning time deposits with balances that equal or exceed \$100,000, as customers with balances of that magnitude are typically more rate-sensitive than customers with smaller balances.

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The following table summarizes the distribution of deposits and the percentage of distribution in each category of deposits for the periods indicated:

### Deposits

|                                      | Year Ended December 31, |               |                  |               |                  |               |
|--------------------------------------|-------------------------|---------------|------------------|---------------|------------------|---------------|
|                                      | 2013                    |               | 2012             |               | 2011             |               |
|                                      | Balance                 | % to<br>Total | Balance          | % to<br>Total | Balance          | % to<br>Total |
|                                      | (Dollars in thousands)  |               |                  |               |                  |               |
| Demand, noninterest-bearing          | \$ 431,085              | 34%           | \$ 727,684       | 49%           | \$ 344,303       | 33%           |
| Demand, interest-bearing             | 195,451                 | 15%           | 155,951          | 10%           | 134,119          | 13%           |
| Savings and money market             | 347,052                 | 27%           | 272,047          | 18%           | 282,478          | 27%           |
| Time deposits under \$100            | 21,646                  | 2%            | 25,157           | 2%            | 28,557           | 2%            |
| Time deposits \$100 and over         | 195,005                 | 15%           | 190,502          | 13%           | 168,874          | 16%           |
| Time deposits brokered               | 55,524                  | 4%            | 97,807           | 7%            | 84,726           | 8%            |
| CDARS money market and time deposits | 40,458                  | 3%            | 10,220           | 1%            | 6,371            | 1%            |
| <br>Total deposits                   | <br>\$ 1,286,221        | <br>100%      | <br>\$ 1,479,368 | <br>100%      | <br>\$ 1,049,428 | <br>100%      |

The Company obtains deposits from a cross-section of the communities it serves. The Company's business is not generally seasonal in nature. The Company is not dependent upon funds from sources outside the United States of America. At December 31, 2013 and 2012, less than 8% and 6%, respectively, of deposits were from public sources.

Deposits totaled \$1.29 billion at December 31, 2013, compared to \$1.48 billion at December 31, 2012. Noninterest-bearing deposits decreased 5% to \$431.1 million at December 31, 2013, from \$455.8 million, (excluding the short-term demand deposits of \$271.9 million to one customer) at December 31, 2012. Interest-bearing demand deposits increased 25% to \$195.5 million at December 31, 2013, from \$156.0 million at December 31, 2012. Savings and money market deposits increased 21% to \$328.0 million (excluding the short-term money market deposits of \$19.0 million to one customer) at December 31, 2013, from \$272.0 million at December 31, 2012. At December 31, 2013, brokered deposits decreased 43% to \$55.5 million, from \$97.8 million at December 31, 2012. Primarily due to \$27.5 million in deposits received from a law firm for legal settlements, CDARS money market and time deposits increased to \$40.5 million at December 31, 2013, compared to \$10.2 million at December 31, 2012. Deposits (excluding all time deposits, CDARS deposits, and short-term deposits from one customer of \$19.0 million at December 31, 2013 and \$271.9 million at December 31, 2012) increased \$70.8 million, or 8%, to \$954.6 million at December 31, 2013, from \$883.8 million at December 31, 2012.

At December 31, 2013, the Company had \$108.0 million (at fair value) of securities pledged for \$98.0 million in certificates of deposits from the State of California. At December 31, 2012, the Company had \$95.3 million (at fair value) of securities pledged for \$85.0 million in certificates of deposits from the State of California.

CDARS deposits were comprised of \$34.8 million of money market accounts and \$5.7 million of time deposits at December 31, 2013. CDARS deposits were comprised of \$5.0 million of money market accounts and \$5.2 million of time deposits at December 31, 2012.



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The following table indicates the contractual maturity schedule of the Company's time deposits of \$100,000 and over, and all CDARS time deposits and brokered deposits as of December 31, 2013:

**Deposit Maturity Distribution**

|                                       | Balance                | % of Total  |
|---------------------------------------|------------------------|-------------|
|                                       | (Dollars in thousands) |             |
| Three months or less                  | \$ 112,032             | 44%         |
| Over three months through six months  | 68,785                 | 27%         |
| Over six months through twelve months | 38,551                 | 15%         |
| Over twelve months                    | 36,830                 | 14%         |
| <b>Total</b>                          | <b>\$ 256,198</b>      | <b>100%</b> |

The Company focuses primarily on providing and servicing business deposit accounts that are frequently over \$100,000 in average balance per account. As a result, certain types of business clients that the Company serves typically carry average deposits in excess of \$100,000. The account activity for some account types and client types necessitates appropriate liquidity management practices by the Company to ensure its ability to fund deposit withdrawals.

***Return on Equity and Assets***

The following table indicates the ratios for return on average assets and average equity, and average equity to average assets for the periods indicated:

|  | 2013   | 2012   | 2011   |
|--|--------|--------|--------|
| Return on average assets               | 0.81%  | 0.73%  | 0.89%  |
| Return on average tangible assets      | 0.81%  | 0.73%  | 0.89%  |
| Return on average equity               | 6.77%  | 5.75%  | 6.02%  |
| Return on average tangible equity      | 6.84%  | 5.83%  | 6.11%  |
| Dividend payout ratio(1)               | 16.60% | N/A    | N/A    |
| Average equity to average assets ratio | 11.90% | 12.72% | 14.82% |

(1)

Percentage is calculated based on dividends paid on common stock and Series C Preferred Stock (on an as converted basis) divided by net income.

***Off-Balance Sheet Arrangements***

In the normal course of business, the Company makes commitments to extend credit to its customers as long as there are no violations of any conditions established in contractual arrangements. These commitments are obligations that represent a potential credit risk to the Company, yet are not reflected in any form within the Company's consolidated balance sheets. Total unused commitments to extend credit were \$377.2 million at December 31, 2013, as compared to \$308.9 million at December 31, 2012. Unused commitments represented 41% and 38% of outstanding gross loans at December 31, 2013 and 2012, respectively.

The effect on the Company's revenues, expenses, cash flows and liquidity from the unused portion of the commitments to provide credit cannot be reasonably predicted, because there is no certainty that the lines of credit will ever be fully utilized. For more information regarding the Company's off-balance sheet arrangements, see Note 14 to the consolidated financial statements located elsewhere herein.

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The following table presents the Company's commitments to extend credit for the periods indicated:

|  | December 31,<br>2013   |               | December 31,<br>2012 |               |
|--|------------------------|---------------|----------------------|---------------|
|  | Fixed Rate             | Variable Rate | Fixed Rate           | Variable Rate |
|  | (Dollars in thousands) |               |                      |               |
| Unused lines of credit and commitments to make loans | \$ 6,136               | \$ 359,955    | \$ 8,410             | \$ 291,191    |
| Standby letters of credit                            |                        | 11,099        | 2,200                | 7,051         |
|  | \$ 6,136               | \$ 371,054    | \$ 10,610            | \$ 298,242    |

**Contractual Obligations**

The contractual obligations of the Company, summarized by type of obligation and contractual maturity, at December 31, 2013, are as follows:

|                                | Less Than<br>One Year  | One to<br>Three Years | Three to<br>Five Years | After<br>Five Years | Total        |
|--------------------------------|------------------------|-----------------------|------------------------|---------------------|--------------|
|                                | (Dollars in thousands) |                       |                        |                     |              |
| Deposits(1)                    | \$ 1,247,172           | \$ 38,961             | \$ 88                  | \$                  | \$ 1,286,221 |
| Operating leases               | 2,565                  | 2,376                 | 1,168                  | 114                 | 6,223        |
| Other long-term liabilities(2) | 936                    | 2,430                 | 2,918                  | 33,084              | 39,368       |
| Total contractual obligations  | \$ 1,250,673           | \$ 43,767             | \$ 4,174               | \$ 33,198           | \$ 1,331,812 |

(1) Deposits with indeterminate maturities, such as demand, savings and money market accounts, are reflected as obligations due in less than one year.

(2) Includes maximum payments related to employee benefit plans, assuming all future vesting conditions are met. Additional information is provided in Note 12 to the consolidated financial statements.

In addition to those obligations listed above, in the normal course of business, the Company will make cash distributions for the payment of interest on interest-bearing deposit accounts and debt obligations, payments for quarterly income tax estimates and contributions to certain employee benefit plans.

**Liquidity and Asset/Liability Management**

Liquidity refers to the Company's ability to maintain cash flows sufficient to fund operations and to meet obligations and other commitments in a timely and cost effective fashion. At various times the Company requires funds to meet short-term cash requirements brought about by loan growth or deposit outflows, the purchase of assets, or liability repayments. An integral part of the Company's ability to manage its liquidity position appropriately is the Company's large base of core deposits, which are generated by offering traditional banking services in its

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service area and which have, historically, been a stable source of funds. To manage liquidity needs properly, cash inflows must be timed to coincide with anticipated outflows or sufficient liquidity resources must be available to meet varying demands. The Company manages liquidity to be able to meet unexpected sudden changes in levels of its assets or deposit liabilities without maintaining excessive amounts of balance sheet liquidity. Excess balance sheet liquidity can negatively impact the Company's interest margin. In order to meet short-term liquidity needs the Company may utilize overnight Federal funds purchase arrangements and other borrowing arrangements with correspondent banks, solicit brokered deposits if cost effective deposits are not available from local sources and maintain collateralized lines of credit with the FHLB and FRB. In addition, the Company can raise cash for temporary needs by selling securities under agreements to repurchase and selling securities available-for-sale.

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One of the measures of liquidity is our loan to deposit ratio. Our loan to deposit ratio was 71.13% at December 31, 2013, compared to 54.91% at December 31, 2012. The loan to deposit ratio was 73.80% at December 31, 2013, and 67.27% at December 31, 2012, excluding the short-term deposits of \$46.5 million and \$271.9 million at the respective periods.

***FHLB and FRB Borrowings and Available Lines of Credit***

The Company has off-balance sheet liquidity in the form of Federal funds purchase arrangements with correspondent banks, including the FHLB and FRB. The Company can borrow from the FHLB on a short-term (typically overnight) or long-term (over one year) basis. The Company had no overnight borrowings from the FHLB at December 31, 2013, and December 31, 2012. The Company had \$253.5 million of loans pledged to the FHLB as collateral on an available line of credit of \$125.3 million at December 31, 2013. The Company had \$192.8 million of loans pledged to the FHLB as collateral on an available line of credit of \$92.9 million at December 31, 2012.

The Company can also borrow from FRB's discount window. The Company had \$323.2 million of loans pledged to the FRB as collateral on an available line of credit of \$241.5 million at December 31, 2013, none of which was outstanding. The Company had \$279.2 million of loans pledged to the FRB as collateral on an available line of credit of \$202.5 million at December 31, 2012, none of which was outstanding.

At December 31, 2013 and 2012, the Company had Federal funds purchase arrangements available of \$55.0 million. There were no Federal funds purchased outstanding at December 31, 2013 or 2012.

The Company may also utilize securities sold under repurchase agreements to manage our liquidity position. There were no securities sold under agreements to repurchase at December 31, 2013 and December 31, 2012.

The following table summarizes the Company's borrowings under its Federal funds purchased, security repurchase arrangements and lines of credit for the periods indicated:

|   | December 31,           |           |          |
|---|------------------------|-----------|----------|
|   | 2013                   | 2012      | 2011     |
|   | (Dollars in thousands) |           |          |
| Average balance during the year           | \$ 58                  | \$ 1,470  | \$ 712   |
| Average interest rate during the year     | 0.20%                  | 0.24%     | 3.37%    |
| Maximum month-end balance during the year | \$                     | \$ 27,000 | \$ 5,000 |
| Average rate at December 31               | N/A                    | N/A       | N/A      |

***Capital Resources***

The Company uses a variety of measures to evaluate capital adequacy. Management reviews various capital measurements on a regular basis and takes appropriate action to ensure that such measurements are within established internal and external guidelines. The external guidelines, which are issued by the Federal Reserve Board and the FDIC, establish a risk adjusted ratio relating capital to different categories of assets and off balance sheet exposures. There are two categories of capital under the Federal Reserve Board and FDIC guidelines: Tier 1 and Tier 2 Capital. Our Tier 1 Capital currently consists of total shareholders' equity (excluding accumulated other comprehensive income or loss) and the proceeds from the issuance of trust preferred securities (trust preferred securities are counted only up to a maximum of 25% of Tier 1 capital), less goodwill and other intangible assets and disallowed deferred tax assets. Our Tier 2 Capital includes the allowances for loan losses and off balance sheet credit losses.

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The following table summarizes risk-based capital, risk-weighted assets, and risk-based capital ratios of the Company:

|                                      | December 31,           |              |              |   |  |
|--------------------------------------|------------------------|--------------|--------------|---|--|
|                                      | 2013                   | 2012         | 2011         |   |  |
|                                      | (Dollars in thousands) |              |              |   |  |
| <b>Capital components:</b>           |                        |              |              |   |  |
| Tier 1 Capital                       | \$ 165,162             | \$ 157,947   | \$ 199,423   |   |  |
| Tier 2 Capital                       | 14,754                 | 13,254       | 12,181       |   |  |
| <br>                                 |                        |              |              |   |  |
| Total risk-based capital             | \$ 179,916             | \$ 171,201   | \$ 211,604   |   |  |
| <br>                                 |                        |              |              |   |  |
| Risk-weighted assets                 | \$ 1,175,813           | \$ 1,054,394 | \$ 965,756   |   |  |
| Average assets (regulatory purposes) | \$ 1,477,082           | \$ 1,378,011 | \$ 1,300,002 |   |  |
|                                      |                        |              |              | <b>Well-Capitalized<br/>Regulatory<br/>Requirements</b> | <b>Minimum<br/>Regulatory<br/>Requirements</b> |
| <b>Capital ratios:</b>               |                        |              |              |   |  |
| Total risk-based capital             | 15.3%                  | 16.2%        | 21.9%        | 10.00%  | 8.00%  |
| Tier 1 risk-based capital            | 14.0%                  | 15.0%        | 20.6%        | 6.00%   | 4.00%  |
| Leverage(1)                          | 11.2%                  | 11.5%        | 15.3%        | N/A   | 4.00%  |

(1) Tier 1 capital divided by quarterly average assets (excluding intangible assets and disallowed deferred tax assets).

The table above presents the capital ratios of the Company computed in accordance with applicable regulatory guidelines and compared to the standards for minimum capital adequacy requirements. The risk-based and leverage capital ratios are also discussed in Item 1 "Business Capital Adequacy Requirements."

The following table summarizes risk-based capital, risk-weighted assets, and risk-based capital ratios of HBC:

|                                     | December 31,           |              |              |  |  |
|-------------------------------------|------------------------|--------------|--------------|--|--|
|                                     | 2013                   | 2012         | 2011         |  |  |
|                                     | (Dollars in thousands) |              |              |  |  |
| <b>Capital components:</b>          |                        |              |              |  |  |
| Tier 1 Capital                      | \$ 149,037             | \$ 147,742   | \$ 178,697   |  |  |
| Tier 2 Capital                      | 14,790                 | 13,262       | 12,207       |  |  |
| <br>                                |                        |              |              |  |  |
| Total risk-based capital            | \$ 163,827             | \$ 161,004   | \$ 190,904   |  |  |
| <br>                                |                        |              |              |  |  |
| Risk-weighted assets                | \$ 1,178,719           | \$ 1,055,061 | \$ 967,898   |  |  |
| Average assets for capital purposes | \$ 1,477,168           | \$ 1,378,238 | \$ 1,301,859 |  |  |

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|                           |       |       |       | Well-Capitalized<br>Regulatory<br>Requirements | Minimum<br>Regulatory<br>Requirements |
|---------------------------|-------|-------|-------|--|---------------------------------------|
| <b>Capital ratios</b>     |       |       |       |  |                                       |
| Total risk-based capital  | 13.9% | 15.3% | 19.7% | 10.00%   | 8.00%                                 |
| Tier 1 risk-based capital | 12.6% | 14.0% | 18.5% | 6.00%  | 4.00%                                 |
| Leverage(1)               | 10.1% | 10.7% | 13.7% | 5.00%  | 4.00%                                 |

- (1) Tier 1 capital divided by quarterly average assets (excluding intangible assets and disallowed deferred tax assets).

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The table above presents the capital ratios of HBC computed in accordance with applicable regulatory guidelines and compared to the standards for minimum capital adequacy requirements under the FDIC's prompt corrective action authority.

Due primarily to the redemption of \$9 million floating-rate subordinated debt in the third quarter of 2013, the Company's total risk-based capital ratio, Tier 1 risk-based capital ratio, and leverage ratio at December 31, 2013 decreased to 15.3%, 14.0%, and 11.2%, compared to 16.2%, 15.0%, and 11.5% at December 31, 2012, respectively. Due primarily to distributions from HBC to HCC totaling \$16 million during 2013, HBC's total risk-based capital ratio, Tier 1 risk-based capital ratio, and leverage ratio at December 31, 2013 decreased to 13.9%, 12.6%, and 10.1%, compared to 15.3%, 14.0%, and 10.7% at December 31, 2012, respectively. However, at December 31, 2013, the Company's and HBC's capital ratios exceed the highest regulatory capital requirement of "well-capitalized" under prompt corrective action provisions.

Quantitative measures established by regulation to help ensure capital adequacy require the Company and HBC to maintain minimum amounts and ratios of total and Tier 1 capital (as defined in the regulations) to risk weighted assets (as defined), and of Tier 1 capital to average assets (as defined). Management believes that, as of December 31, 2013, and December 31, 2012, the Company and HBC met all capital adequacy guidelines to which they were subject.

As of December 31, 2013, HBC was categorized as "well-capitalized" under the regulatory framework for prompt corrective action. There are no conditions or events since December 31, 2013 that management believes have changed the categorization of the Company or HBC as well-capitalized.

At December 31, 2013, the Company had total shareholders' equity of \$173.4 million, including \$19.5 million in preferred stock, \$132.6 million in common stock, \$25.3 million in retained earnings, and (\$4.0) million of accumulated other comprehensive loss.

The accumulated other comprehensive loss of (\$4.0) million at December 31, 2013, decreased from accumulated other comprehensive income of \$2.7 million at December 31, 2012. The decrease was primarily due to an unrealized loss on securities available-for-sale of (\$1.4) million, net of taxes, at December 31, 2013, compared to an unrealized gain on securities available-for-sale of \$6.9 million, net of taxes, at December 31, 2012. The components of other comprehensive loss, net of taxes, at December 31, 2013 include the following: an unrealized loss on available-for-sale securities of (\$1.4) million; the remaining unamortized unrealized gain on securities available-for-sale transferred to held-to-maturity of \$465,000; a liability adjustment on split dollar insurance contracts of (\$1.9) million; a liability adjustment on the supplemental executive retirement plan of (\$2.2) million; and an unrealized gain on interest-only strip from SBA loans of \$956,000.

***Mandatory Redeemable Cumulative Trust Preferred Securities***

To enhance regulatory capital and to provide liquidity, the Company, through unconsolidated subsidiary grantor trusts, issued the following mandatory redeemable cumulative trust preferred securities of subsidiary grantor trusts: In the first quarter of 2000, the Company issued \$7.0 million principal amount of 10.875% fixed-rate subordinated debt due on March 8, 2030, and common securities of \$217,000 to a subsidiary trust, which in turn issued a similar amount of trust preferred securities. In the third quarter of 2000, the Company issued \$7.0 million principal amount of 10.60% fixed-rate subordinated debt due on September 7, 2030, and common securities of \$206,000 to a subsidiary trust, which in turn issued a similar amount of trust preferred securities. In the third quarter of 2001, the Company issued \$5.2 million aggregate principal amount of Floating Rate Junior Subordinated Deferrable Interest Debentures due on July 31, 2031 to a subsidiary trust, which in turn issued a similar amount of trust preferred securities. In the third quarter of 2002, the Company issued \$4.1 million of aggregate principal amount of Floating Rate Junior Subordinated Deferrable Interest Debentures due on September 26, 2032 to a subsidiary trust, which in turn issued a similar amount of trust preferred securities. The subordinated debt was recorded as

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a component of long-term debt and included the value of the common stock issued by the trusts to the Company. The common stock was recorded as other assets for the amount issued. Under applicable regulatory guidelines, the trust preferred securities qualified as Tier I capital. The subsidiary trusts were not consolidated in the Company's consolidated financial statements.

During the third quarter of 2012, the Company redeemed its 10.875% fixed-rate subordinated debentures in the amount of \$7 million issued to Heritage Capital Trust I and the Company's 10.600% fixed-rate subordinated debentures in the amount of \$7 million issued to Heritage Statutory Trust I. The related trust securities issued by Capital Trust I and Statutory Trust I were also redeemed in connection with the subordinated debt redemption and the trusts were dissolved.

During the third quarter of 2013, the Company redeemed its Company's Floating Rate Junior Subordinated Debentures due July 31, 2031 in the amount of \$5 million issued to Heritage Statutory Trust II and the Company's Floating Rate Junior Subordinated Debentures due September 26, 2032, in the amount of \$4 million issued to Heritage Statutory Trust III (collectively referred to as the "Floating-Rate Sub Debt"). The \$5 million Floating-Rate Sub Debt was redeemed on July 31, 2013. The \$4 million Floating-Rate Sub Debt was redeemed on September 26, 2013. The related trust securities issued by Statutory Trust II and Statutory Trust III were also redeemed in connection with the subordinated debt redemption and the trusts were dissolved. The Company used available cash and proceeds from a \$9 million distribution from the Bank for the redemption. The Company incurred a total charge of \$167,000 in the second quarter of 2013, representing the agency origination fees associated with the Floating Rate Sub Debt. On an annual basis, the redemption of the Floating Rate Sub Debt will eliminate approximately \$360,000 in interest expense.

***U.S. Treasury Capital Purchase Program***

The Company received \$40 million in November 2008 through the issuance of its Series A Preferred Stock and a warrant to purchase 462,963 shares of its common stock to the Treasury through the U.S. Treasury Capital Purchase Program. The Series A Preferred Stock qualified as a component of Tier 1 capital.

On March 7, 2012, in accordance with approvals received from the U.S. Treasury and the Federal Reserve, the Company repurchased all of the Series A Preferred Stock and paid the related accrued and unpaid dividends. The repurchase of the Series A Preferred Stock eliminates \$2.0 million in annual dividends. On June 12, 2013, the Company completed the repurchase of the common stock warrant for \$140,000.

***Series C Preferred Stock***

On June 21, 2010, the Company issued to various institutional investors 21,004 shares of newly issued Series C Convertible Perpetual Preferred Stock ("Series C Preferred Stock"). The Series C Preferred Stock is mandatorily convertible into 5,601,000 shares of common stock at a conversion price of \$3.75 per share upon a subsequent transfer of the Series C Preferred stock to third parties not affiliates with the holder in a widely dispersed offering. The Series C Preferred Stock is non-voting except in the case of certain transactions that would affect the rights of the holders of the Series C Preferred Stock or applicable law. Holders of Series C Preferred Stock will receive dividends if and only to the extent dividends are paid to holders of common stock. The Series C Preferred Stock is not redeemable by the Company or by the holders and has a liquidation preference of \$1,000 per share. The Series C Preferred Stock ranks senior to the Company's common stock.

**Market Risk**

Market risk is the risk of loss of future earnings, fair values, or future cash flows that may result from changes in the price of a financial instrument. The value of a financial instrument may change as a result of



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changes in interest rates, foreign currency exchange rates, commodity prices, equity prices and other market changes that affect market risk sensitive instruments. Market risk is attributed to all market risk sensitive financial instruments, including securities, loans, deposits and borrowings, as well as the Company's role as a financial intermediary in customer-related transactions. The objective of market risk management is to avoid excessive exposure of the Company's earnings and equity to loss and to reduce the volatility inherent in certain financial instruments.

**Interest Rate Management**

Market risk arises from changes in interest rates, exchange rates, commodity prices and equity prices. The Company's market risk exposure is primarily that of interest rate risk, and it has established policies and procedures to monitor and limit earnings and balance sheet exposure to changes in interest rates. The Company does not engage in the trading of financial instruments, nor does the Company have exposure to currency exchange rates.

The principal objective of interest rate risk management (often referred to as "asset/liability management") is to manage the financial components of the Company in a manner that will optimize the risk/reward equation for earnings and capital in relation to changing interest rates. The Company's exposure to market risk is reviewed on a regular basis by the Asset/Liability Committee. Interest rate risk is the potential of economic losses due to future interest rate changes. These economic losses can be reflected as a loss of future net interest income and/or a loss of current fair market values. The objective is to measure the effect on net interest income and to adjust the balance sheet to minimize the inherent risk while at the same time maximizing income. Management realizes certain risks are inherent, and that the goal is to identify and manage the risks. Management uses two methodologies to manage interest rate risk: (i) a standard GAP analysis; and (ii) an interest rate shock simulation model.

The planning of asset and liability maturities is an integral part of the management of an institution's net interest margin. To the extent maturities of assets and liabilities do not match in a changing interest rate environment, the net interest margin may change over time. Even with perfectly matched repricing of assets and liabilities, risks remain in the form of prepayment of loans or securities or in the form of delays in the adjustment of rates of interest applying to either earning assets with floating rates or to interest bearing liabilities. The Company has generally been able to control its exposure to changing interest rates by maintaining primarily floating interest rate loans and a majority of its time certificates with relatively short maturities.

Interest rate changes do not affect all categories of assets and liabilities equally or at the same time. Varying interest rate environments can create unexpected changes in prepayment levels of assets and liabilities, which may have a significant effect on the net interest margin and are not reflected in the interest sensitivity analysis table. Because of these factors, an interest sensitivity gap report may not provide a complete assessment of the exposure to changes in interest rates.

The Company uses modeling software for asset/liability management in order to simulate the effects of potential interest rate changes on the Company's net interest margin, and to calculate the estimated fair values of the Company's financial instruments under different interest rate scenarios. The program imports current balances, interest rates, maturity dates and repricing information for individual financial instruments, and incorporates assumptions on the characteristics of embedded options along with pricing and duration for new volumes to project the effects of a given interest rate change on the Company's interest income and interest expense. Rate scenarios consisting of key rate and yield curve projections are run against the Company's investment, loan, deposit and borrowed funds portfolios. These rate projections can be shocked (an immediate and parallel change in all base rates, up or down) and ramped (an incremental increase or decrease in rates over a specified time period), based on current trends and econometric models or stable economic conditions (unchanged from current actual levels).

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The following table sets forth the estimated changes in the Company's net interest income that would result from the designated instantaneous parallel shift in interest rates noted, as of December 31, 2013. Computations of prospective effects of hypothetical interest rate changes are based on numerous assumptions including relative levels of market interest rates, loan prepayments and deposit decay, and should not be relied upon as indicative of actual results.

|  | <b>Increase/(Decrease) in<br/>Estimated Net<br/>Interest Income</b> |                |
|--|---|----------------|
|  | <b>Amount</b>   | <b>Percent</b> |
|  | <b>(Dollars in thousands)</b>                                       |                |
| <b>Change in Interest Rates (basis points)</b> |   |                |
| +400   | \$ 12,345   | 23.4%          |
| +300   | \$ 9,181  | 17.4%          |
| +200   | \$ 5,933  | 11.2%          |
| +100   | \$ 2,770  | 5.3%           |
| 0  | \$  | 0.0%           |
| -100   | \$ (4,080)  | -7.7%          |
| -200   | \$ (8,815)  | -16.7%         |

This data does not reflect any actions that we may undertake in response to changes in interest rates such as changes in rates paid on certain deposit accounts based on local competitive factors, which could reduce the actual impact on net interest income, if any.

As with any method of gauging interest rate risk, there are certain shortcomings inherent to the methodology noted above. The model assumes interest rate changes are instantaneous parallel shifts in the yield curve. In reality, rate changes are rarely instantaneous. The use of the simplifying assumption that short-term and long-term rates change by the same degree may also misstate historic rate patterns, which rarely show parallel yield curve shifts. Further, the model assumes that certain assets and liabilities of similar maturity or period to repricing will react in the same way to changes in rates. In reality, certain types of financial instruments may react in advance of changes in market rates, while the reaction of other types of financial instruments may lag behind the change in general market rates. Additionally, the methodology noted above does not reflect the full impact of annual and lifetime restrictions on changes in rates for certain assets, such as adjustable rate loans. When interest rates change, actual loan prepayments and actual early withdrawals from certificates may deviate significantly from the assumptions used in the model. Finally, this methodology does not measure or reflect the impact that higher rates may have on adjustable-rate loan clients' ability to service their debt. All of these factors are considered in monitoring the Company's exposure to interest rate risk.

**ITEM 7A QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

As a financial institution, the Company's primary component of market risk is interest rate volatility. Fluctuations in interest rates will ultimately impact both the level of income and expense recorded on most of the Company's assets and liabilities and the market value of all interest-earning assets, other than those which have a short term to maturity. Based upon the nature of the Company's operations, the Company is not subject to foreign exchange or commodity price risk. The Company has no market risk sensitive instruments held for trading purposes. As of December 31, 2013, the Company did not use interest rate derivatives to hedge its interest rate risk.

The information concerning quantitative and qualitative disclosure or market risk called for by Item 305 of Regulation S-K is included as part of Item 7 of this report.

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**ITEM 8 FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

The financial statements and report of the Independent Registered Public Accounting Firm are set forth on pages 87 through 141.

**ITEM 9 CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURES**

None.

**ITEM 9A CONTROLS AND PROCEDURES**

**Disclosure Control and Procedures**

The Company has carried out an evaluation, under the supervision and with the participation of the Company's management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of December 31, 2013. As defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), disclosure controls and procedures are controls and procedures designed to reasonably assure that information required to be disclosed in our reports filed or submitted under the Exchange Act are recorded, processed, summarized and reported on a timely basis. Disclosure controls are also designed to reasonably assure that such information is accumulated and communicated to our management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. Based upon their evaluation, our Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls were effective as of December 31, 2013, the period covered by this report.

**Management's Annual Report on Internal Control over Financial Reporting**

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting. As defined in Rule 13a-15(f) under the Exchange Act, internal control over financial reporting is a process designed by, or under the supervision of, a company's principal executive and principal financial officers and effected by a company's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. It includes those policies and procedures that:

Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of a company;

Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of a company are being made only in accordance with authorizations of management and the board of directors of the company; and

Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of a company's assets that could have a material effect on its financial statements.

Because of the inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

The Company's management has used the criteria established in the 1992 *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") to evaluate the effectiveness of the Company's internal control over financial reporting. Management has

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selected the COSO framework for its evaluation as it is a control framework recognized by the SEC and the Public Company Accounting Oversight Board, that is free from bias, permits reasonably consistent qualitative and quantitative measurement of the Company's internal controls, is sufficiently complete so that relevant controls are not omitted and is relevant to an evaluation of internal controls over financial reporting.

Based on our assessment, management has concluded that our internal control over financial reporting, based on criteria established in the 1992 *Internal Control - Integrated Framework* issued by COSO was effective as of December 31, 2013.

The independent registered public accounting firm of Crowe Horwath LLP, as auditors of our consolidated financial statements, has issued an attestation report on the effectiveness of management's internal control over financial reporting based on criteria established in the 1992 *"Internal Control - Integrated Framework,"* issued by COSO.

**Inherent Limitations on Effectiveness of Controls**

The Company's management, including the Chief Executive Officer and Chief Financial Officer, does not expect that our disclosure controls or our internal control over financial reporting will prevent or detect all errors and fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. The design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Further, because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that misstatements due to error or fraud will not occur or that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error or mistake. Controls can also be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is based in part on certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Projections of any evaluation of controls effectiveness to future periods are subject to risks. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with policies or procedures.

**Changes in Internal Control over Financial Reporting**

There was no change in our internal control over financial reporting that occurred during the year ended December 31, 2013 that has materially affected or is reasonably likely to materially affect our internal control over financial reporting.

**ITEM 9B OTHER INFORMATION**

None.

**PART III**

**ITEM 10 DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE**

Information required by this item will be contained in our Definitive Proxy Statement for our 2014 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A with the Securities and Exchange Commission within 120 days of December 31, 2013. Such information is incorporated herein by reference.

We have adopted a code of ethics that applies to our Chief Executive Officer, Chief Financial Officer, and to our other principal financial officers. The code of ethics is available at the Governance Documents section of our website at [www.heritagecommercecorp.com](http://www.heritagecommercecorp.com). We intend to disclose future amendments to, or

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waivers from, certain provisions of our code of ethics on the above website within four business days following the date of such amendment or waiver.

**ITEM 11 EXECUTIVE COMPENSATION**

Information required by this item will be contained in our Definitive Proxy Statement for our 2014 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A with the Securities and Exchange Commission within 120 days of December 31, 2013. Such information is incorporated herein by reference.

**ITEM 12 SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS**

Information required by this item will be contained in our Definitive Proxy Statement for our 2014 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A with the Securities and Exchange Commission within 120 days of December 31, 2013. Such information is incorporated herein by reference.

**ITEM 13 CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE**

Information required by this item will be contained in our Definitive Proxy Statement for our 2014 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A with the Securities and Exchange Commission within 120 days of December 31, 2013. Such information is incorporated herein by reference.

**ITEM 14 PRINCIPAL ACCOUNTANT FEES AND SERVICES**

Information required by this item will be contained in our Definitive Proxy Statement for our 2014 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A with the Securities and Exchange Commission within 120 days of December 31, 2013. Such information is incorporated herein by reference.

**PART IV**

**ITEM 15 EXHIBITS AND FINANCIAL STATEMENT SCHEDULES**

**(a)(1) FINANCIAL STATEMENTS**

The Financial Statements of the Company and the Report of Independent Registered Public Accounting Firm are set forth on pages 87 through 141.

**(a)(2) FINANCIAL STATEMENT SCHEDULES**

All schedules to the Financial Statements are omitted because of the absence of the conditions under which they are required or because the required information is included in the Financial Statements or accompanying notes.

**(a)(3) EXHIBITS**

The exhibit list required by this Item is incorporated by reference to the Exhibit Index included in this report.

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### SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Company has duly caused this report on Form 10-K to be signed on its behalf by the undersigned thereunto duly authorized.

HERITAGE COMMERCE CORP

BY:           /s/ WALTER T. KACZMAREK          

Walter T. Kaczmarek  
*Chief Executive Officer*

DATE: March 7, 2014

Pursuant to the requirements of Section 13 of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed below by the following persons on behalf of the registrant and in the capacities and on the date indicated:

| <b>Signature</b>  | <b>Title</b>  | <b>Date</b>   |
|---|---|---------------|
| <u>          /s/ FRANK G. BISCEGLIA          </u><br>Frank G. Bisceglia       | Director  | March 7, 2014 |
| <u>          /s/ JACK W. CONNER          </u><br>Jack W. Conner               | Director and Chairman of the Board  | March 7, 2014 |
| <u>          /s/ JOHN M. EGGEMEYER          </u><br>John M. Eggemeyer         | Director  | March 7, 2014 |
| <u>          /s/ CELESTE V. FORD          </u><br>Celeste V. Ford             | Director  | March 7, 2014 |
| <u>          /s/ STEVEN L. HALLGRIMSON          </u><br>Steven L. Hallgrimson | Director  | March 7, 2014 |
| <u>          /s/ WALTER T. KACZMAREK          </u><br>Walter T. Kaczmarek     | Director and Chief Executive Officer and President (Principal Executive Officer)                  | March 7, 2014 |
| <u>          /s/ LAWRENCE D. MCGOVERN          </u><br>Lawrence D. McGovern   | Executive Vice President and Chief Financial Officer (Principal Financial and Accounting Officer) | March 7, 2014 |
| <u>          /s/ ROBERT T. MOLES          </u><br>Robert T. Moles             | Director  |               |
| <u>          /s/ HUMPHREY P. POLANEN          </u><br>Humphrey P. Polanen     | Director  | March 7, 2014 |
| <u>          /s/ LAURA RODEN          </u><br>Laura Roden                     | Director  | March 7, 2014 |

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Laura Roden

/s/ CHARLES T. TOENISKOETTER

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Charles T. Toeniskoetter Director

March 7, 2014

/s/ RANSON W. WEBSTER

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Ranson W. Webster Director

March 7, 2014

/s/ W. KIRK WYCOFF

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W. Kirk Wycoff Director

March 7, 2014

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**HERITAGE COMMERCE CORP**

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DECEMBER 31, 2013**

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

Board of Directors  
Heritage Commerce Corp  
San Jose, California

We have audited the accompanying consolidated balance sheets of Heritage Commerce Corp (the "Company") as of December 31, 2013 and 2012, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity and cash flows for each of the years in the three-year period ended December 31, 2013. We also have audited Heritage Commerce Corp's internal control over financial reporting as of December 31, 2013, based on criteria established in the 1992 *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Heritage Commerce Corp's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Annual Report on Internal Control over Financial Reporting included in Item 9A in this Form 10-K. Our responsibility is to express an opinion on these financial statements and an opinion on the Company's internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Heritage Commerce Corp as of December 31, 2013 and 2012, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2013 in conformity with accounting principles generally accepted in the United States of

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America. Also in our opinion, Heritage Commerce Corp maintained, in all material respects, effective internal control over financial reporting as of December 31, 2013, based on criteria established in the 1992 *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

/s/ Crowe Horwath LLP

Sacramento, California  
March 7, 2014

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**HERITAGE COMMERCE CORP**  
**CONSOLIDATED BALANCE SHEETS**

|  | December 31,<br>2013   | December 31,<br>2012 |
|--|------------------------|----------------------|
|  | (Dollars in thousands) |                      |
| <b>Assets</b>  |                        |                      |
| Cash and due from banks  | \$ 20,158              | \$ 16,520            |
| Interest-bearing deposits in other financial institutions  | 92,447                 | 357,045              |
| <br>   |                        |                      |
| Total cash and cash equivalents  | 112,605                | 373,565              |
| Securities available-for-sale, at fair value   | 280,100                | 367,912              |
| Securities held-to-maturity, at amortized cost (fair value of \$86,032 at December 31, 2013 and \$51,073 at December 31, 2012) | 95,921                 | 51,472               |
| Loans held-for-sale SBA, at lower of cost or market, including deferred costs  | 3,148                  | 3,409                |
| Loans, net of deferred fees  | 914,913                | 812,313              |
| Allowance for loan losses  | (19,164)               | (19,027)             |
| <br>   |                        |                      |
| Loans, net   | 895,749                | 793,286              |
| Federal Home Loan Bank and Federal Reserve Bank stock, at cost   | 10,435                 | 10,728               |
| Company owned life insurance   | 50,012                 | 48,358               |
| Premises and equipment   | 7,240                  | 7,469                |
| Intangible assets  | 1,527                  | 2,000                |
| Accrued interest receivable and other assets   | 34,895                 | 35,113               |
| <br>   |                        |                      |
| Total assets   | \$ 1,491,632           | \$ 1,693,312         |
| <b>Liabilities and Shareholders' Equity</b>  |                        |                      |
| Liabilities:   |                        |                      |
| Deposits:  |                        |                      |
| Demand, noninterest-bearing  | \$ 431,085             | \$ 727,684           |
| Demand, interest-bearing   | 195,451                | 155,951              |
| Savings and money market   | 347,052                | 272,047              |
| Time deposits-under \$100  | 21,646                 | 25,157               |
| Time deposits-\$100 and over   | 195,005                | 190,502              |
| Time deposits-brokered   | 55,524                 | 97,807               |
| CDARS money market and time deposits   | 40,458                 | 10,220               |
| <br>   |                        |                      |
| Total deposits   | 1,286,221              | 1,479,368            |
| Subordinated debt  |                        | 9,279                |
| Accrued interest payable and other liabilities   | 32,015                 | 34,924               |
| <br>   |                        |                      |
| Total liabilities  | 1,318,236              | 1,523,571            |
| Commitments and contingencies (Notes 6 and 14)   |                        |                      |

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Shareholders' equity:

|   |              |              |
|---|--------------|--------------|
| Preferred stock, no par value; 10,000,000 shares authorized   |              |              |
| Series C convertible perpetual preferred stock, 21,004 shares issued and outstanding at December 31, 2013 and December 31, 2012 (liquidation preference of \$21,004 at December 31, 2013 and December 31, 2012) | 19,519       | 19,519       |
| Common stock, no par value; 60,000,000 shares authorized; 26,350,938 shares issued and outstanding at December 31, 2013 and 26,322,147 shares issued and outstanding at December 31, 2012                       | 132,561      | 131,820      |
| Retained earnings   | 25,345       | 15,721       |
| Accumulated other comprehensive income (loss)   | (4,029)      | 2,681        |
| <br>  |              |              |
| Total shareholders' equity  | 173,396      | 169,741      |
| <br>  |              |              |
| Total liabilities and shareholders' equity  | \$ 1,491,632 | \$ 1,693,312 |

See notes to consolidated financial statements

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**HERITAGE COMMERCE CORP**  
**CONSOLIDATED STATEMENTS OF INCOME**

Year Ended December 31,

2013                      2012                      2011  
(Dollars in thousands, except per share data)

|   |           |           |           |
|---|-----------|-----------|-----------|
| <b>Interest income:</b>                                   |           |           |           |
| Loans, including fees                                     | \$ 41,570 | \$ 40,800 | \$ 42,769 |
| Securities, taxable                                       | 9,472     | 11,519    | 9,088     |
| Securities, non-taxable                                   | 1,530     | 112       |           |
| Interest-bearing deposits in other financial institutions | 214       | 134       | 174       |
| <br>  |           |           |           |
| Total interest income                                     | 52,786    | 52,565    | 52,031    |
| <br>  |           |           |           |
| <b>Interest expense:</b>                                  |           |           |           |
| Deposits  | 2,369     | 2,800     | 3,942     |
| Subordinated debt   | 229       | 1,383     | 1,871     |
| Short-term borrowings                                     | 2         | 4         | 38        |
| Repurchase agreements                                     |           |           | 24        |
| <br>  |           |           |           |
| Total interest expense                                    | 2,600     | 4,187     | 5,875     |
| <br>  |           |           |           |
| Net interest income before provision for loan losses      | 50,186    | 48,378    | 46,156    |
| Provision (credit) for loan losses                        | (816)     | 2,784     | 4,469     |
| <br>  |           |           |           |
| Net interest income after provision for loan losses       | 51,002    | 45,594    | 41,687    |
| <br>  |           |           |           |
| <b>Noninterest income:</b>                                |           |           |           |
| Service charges and fees on deposit accounts              | 2,457     | 2,333     | 2,355     |
| Increase in cash surrender value of life insurance        | 1,654     | 1,720     | 1,706     |
| Servicing income  | 1,446     | 1,743     | 1,743     |
| Gain on sales of SBA loans                                | 449       | 702       | 1,461     |
| Gain on sales of securities                               | 38        | 1,560     | 459       |
| Other   | 1,170     | 807       | 698       |
| <br>  |           |           |           |
| Total noninterest income                                  | 7,214     | 8,865     | 8,422     |
| <br>  |           |           |           |
| <b>Noninterest expense:</b>                               |           |           |           |
| Salaries and employee benefits                            | 23,450    | 21,722    | 20,574    |
| Occupancy and equipment                                   | 4,043     | 3,997     | 4,083     |
| Professional fees   | 2,588     | 2,876     | 2,861     |
| Software subscriptions                                    | 1,289     | 1,149     | 1,078     |
| Low income housing investment losses                      | 1,252     | 1,195     | 1,035     |
| Data processing   | 1,078     | 983       | 876       |

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|   |               |               |               |
|---|---------------|---------------|---------------|
| Insurance expense                                   | 1,032         | 911           | 941           |
| FDIC deposit insurance premiums                     | 894           | 918           | 1,294         |
| Correspondent bank charges                          | 684           | 611           | 545           |
| Premium on redemption of subordinated debt          |               | 601           |               |
| Foreclosed assets                                   | (251)         | (45)          | 389           |
| Other   | 5,663         | 5,338         | 5,896         |
| <b>Total noninterest expense</b>                    | <b>41,722</b> | <b>40,256</b> | <b>39,572</b> |
| <br>  |               |               |               |
| Income before income taxes                          | 16,494        | 14,203        | 10,537        |
| Income tax expense (benefit)                        | 4,954         | 4,294         | (834)         |
| <br>  |               |               |               |
| Net income  | 11,540        | 9,909         | 11,371        |
| Dividends and discount accretion on preferred stock | (336)         | (1,206)       | (2,333)       |
| <br>  |               |               |               |
| Net income available to common shareholders         | \$ 11,204     | \$ 8,703      | \$ 9,038      |
| <br>  |               |               |               |
| Earnings per common share:                          |               |               |               |
| Basic   | \$ 0.36       | \$ 0.27       | \$ 0.28       |
| Diluted   | \$ 0.36       | \$ 0.27       | \$ 0.28       |

See notes to consolidated financial statements

Table of Contents**HERITAGE COMMERCE CORP****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

|  | Year Ended December 31, |           |           |
|--|-------------------------|-----------|-----------|
|  | 2013                    | 2012      | 2011      |
|  | (Dollars in thousands)  |           |           |
| Net income   | \$ 11,540               | \$ 9,909  | \$ 11,371 |
| Other comprehensive income (loss):   |                         |           |           |
| Change in net unrealized holding gains (losses) on available-for-sale securities and I/O strips                                  | (14,302)                | 4,451     | 12,050    |
| Deferred income taxes  | 6,007                   | (1,869)   | (5,061)   |
| Change in net unamortized unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity | (54)                    | 857       |           |
| Deferred income taxes  | 23                      | (360)     |           |
| Reclassification adjustment for gains realized in income   | (38)                    | (1,560)   | (459)     |
| Deferred income taxes  | 16                      | 655       | 193       |
| Change in unrealized gains (losses) on securities and I/O strips, net of deferred income taxes                                   | (8,348)                 | 2,174     | 6,723     |
| Change in net pension and other benefit plan liability adjustment  | 2,825                   | (772)     | (1,926)   |
| Deferred income taxes  | (1,187)                 | 324       | 809       |
| Change in pension and other benefit plan liability, net of deferred income taxes   | 1,638                   | (448)     | (1,117)   |
| Other comprehensive income (loss)  | (6,710)                 | 1,726     | 5,606     |
| Total comprehensive income   | \$ 4,830                | \$ 11,635 | \$ 16,977 |

See notes to consolidated financial statements

Table of Contents**HERITAGE COMMERCE CORP****CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**

Years Ended December 31, 2013, 2012, and 2011

|   | Preferred Stock |           |            | Common Stock |            | Retained                              | Accumulated                                 | Total      |
|---|-----------------|-----------|------------|--------------|------------|---------------------------------------|---|------------|
|   | Shares          | Amount    | Discount   | Shares       | Amount     | Earnings/<br>(Accumulated<br>Deficit) | Other<br>Comprehensive<br>Income/<br>(Loss) |            |
| (Dollars in thousands)  |                 |           |            |              |            |                                       |   |            |
| <b>Balance, January 1, 2011</b>                                       | 61,004          | \$ 59,365 | \$ (1,227) | 26,233,001   | \$ 130,531 | \$ (1,866)                            | \$ (4,651)                                  | \$ 182,152 |
| Net income  |                 |           |            |              |            | 11,371                                |   | 11,371     |
| Other comprehensive income  |                 |           |            |              |            |                                       | 5,606                                       | 5,606      |
| Issuance of restricted stock awards                                   |                 |           |            | 62,000       |            |                                       |   |            |
| Amortization of restricted stock awards, net of forfeitures and taxes |                 |           |            |              | 75         |                                       |   | 75         |
| Cash dividends accrued on Series A preferred stock                    |                 |           |            |              |            | (1,939)                               |   | (1,939)    |
| Accretion of discount on Series A preferred stock                     |                 |           | 394        |              |            | (394)                                 |   |            |
| Stock option expense, net of forfeitures and taxes                    |                 |           |            |              | 566        |                                       |   | 566        |
| <b>Balance, December 31, 2011</b>                                     | 61,004          | 59,365    | (833)      | 26,295,001   | 131,172    | 7,172                                 | 955   | 197,831    |
| Net income  |                 |           |            |              |            | 9,909                                 |   | 9,909      |
| Other comprehensive income  |                 |           |            |              |            |                                       | 1,726                                       | 1,726      |
| Repurchase of Series A preferred stock                                | (40,000)        | (40,000)  |            |              |            |                                       |   | (40,000)   |
| Series A preferred stock capitalized offering costs                   |                 | 154       |            |              |            | (154)                                 |   |            |
| Issuance (forfeitures) of restricted stock awards, net                |                 |           |            | 21,500       |            |                                       |   |            |
| Amortization of restricted stock awards, net of forfeitures and taxes |                 |           |            |              | 148        |                                       |   | 148        |
| Cash dividends accrued on Series A preferred stock                    |                 |           |            |              |            | (373)                                 |   | (373)      |
| Accretion of discount on Series A preferred stock                     |                 |           | 833        |              |            | (833)                                 |   |            |
| Stock option expense, net of forfeitures and taxes                    |                 |           |            |              | 461        |                                       |   | 461        |
| Stock options exercised   |                 |           |            | 5,646        | 39         |                                       |   | 39         |
| <b>Balance, December 31, 2012</b>                                     | 21,004          | 19,519    |            | 26,322,147   | 131,820    | 15,721                                | 2,681                                       | 169,741    |
| Net income  |                 |           |            |              |            | 11,540                                |   | 11,540     |
| Other comprehensive loss  |                 |           |            |              |            |                                       | (6,710)                                     | (6,710)    |
| Issuance of restricted stock awards, net                              |                 |           |            | 10,000       |            |                                       |   |            |
| Repurchase of warrant   |                 |           |            |              | (140)      |                                       |   | (140)      |
| Amortization of restricted stock awards, net of forfeitures and taxes |                 |           |            |              | 200        |                                       |   | 200        |
| Cash dividend declared, \$0.06 per share                              |                 |           |            |              |            | (1,916)                               |   | (1,916)    |
| Stock option expense, net of forfeitures and taxes                    |                 |           |            |              | 593        |                                       |   | 593        |
| Stock options exercised   |                 |           |            | 18,791       | 88         |                                       |   | 88         |
| <b>Balance, December 31, 2013</b>                                     | 21,004          | \$ 19,519 | \$         | 26,350,938   | \$ 132,561 | \$ 25,345                             | \$ (4,029)                                  | \$ 173,396 |



See notes to consolidated financial statements

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**HERITAGE COMMERCE CORP**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

|   | Year ended December 31, |           |           |
|---|-------------------------|-----------|-----------|
|   | 2013                    | 2012      | 2011      |
|   | (Dollars in thousands)  |           |           |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                      |                         |           |           |
| Net income  | \$ 11,540               | \$ 9,909  | \$ 11,371 |
| Adjustments to reconcile net income to net cash provided by operating activities: |                         |           |           |
| Amortization of discounts and premiums on securities                              | 2,231                   | 2,588     | 1,634     |
| Gain on sale of securities available-for-sale                                     | (38)                    | (1,560)   | (459)     |
| Gain on sale of SBA loans   | (449)                   | (702)     | (1,461)   |
| Proceeds from sale of SBA loans originated for sale                               | 6,174                   | 10,040    | 16,857    |
| Net change in SBA loans originated for sale                                       | (9,234)                 | (11,994)  | (7,634)   |
| Writedowns on other loans held-for-sale   |                         |           | 29        |
| Provision (credit) for loan losses  | (816)                   | 2,784     | 4,469     |
| Increase in cash surrender value of life insurance                                | (1,654)                 | (1,720)   | (1,706)   |
| Depreciation and amortization   | 729                     | 750       | 766       |
| Amortization of other intangible assets   | 473                     | 491       | 523       |
| Gains on sale of foreclosed assets, net   | (243)                   | (530)     | (10)      |
| Stock option expense, net   | 593                     | 461       | 566       |
| Amortization of restricted stock awards, net                                      | 200                     | 148       | 75        |
| Effect of changes in:   |                         |           |           |
| Accrued interest receivable and other assets                                      | 4,694                   | 4,717     | (675)     |
| Accrued interest payable and other liabilities                                    | 2,063                   | 659       | (2,904)   |
| Net cash provided by operating activities   | 16,263                  | 16,041    | 21,441    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                      |                         |           |           |
| Purchase of securities available-for-sale   | (17,844)                | (154,414) | (233,092) |
| Purchase of securities held-to-maturity   | (51,044)                | (33,317)  |           |
| Maturities/paydowns/calls of securities available-for-sale                        | 62,531                  | 108,026   | 52,427    |
| Maturities/paydowns/calls of securities held-to-maturity                          | 3,851                   | 1,553     |           |
| Proceeds from sales of securities available-for-sale                              | 26,944                  | 40,587    | 45,014    |
| Net change in other loans transferred to held-for-sale                            |                         |           | 49        |
| Proceeds from sale of other loans transferred held-for-sale                       |                         | 220       | 1,769     |
| Net change in loans   | (97,910)                | (54,042)  | 68,155    |
| Changes in Federal Home Loan Bank stock and other investments                     | 293                     | (803)     | (751)     |
| Purchase of company owned life insurance  |                         | (250)     | (1,000)   |
| Purchase of premises and equipment  | (500)                   | (239)     | (349)     |
| Proceeds from sale of foreclosed assets   | 850                     | 2,148     | 3,639     |
| Net cash used in investing activities   | (72,829)                | (90,531)  | (64,139)  |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                      |                         |           |           |
| Net change in deposits  | (193,147)               | 429,940   | 55,510    |
| Repurchase of warrant   | (140)                   |           |           |
| Exercise of stock options   | 88                      | 39        |           |
| Repayment of preferred stock  |                         | (40,000)  |           |
| Redemption of subordinated debt   | (9,279)                 | (14,423)  |           |
| Net change in securities sold under agreement to repurchase                       |                         |           | (5,000)   |
| Net change in short-term borrowings   |                         |           | (2,445)   |
| Payment of cash dividends Series A preferred stock                                |                         | (373)     | (4,672)   |
| Payment of cash dividends   | (1,916)                 |           |           |

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|  |            |            |           |
|--|------------|------------|-----------|
| Net cash provided by (used in) financing activities  | (204,394)  | 375,183    | 43,393    |
| Net (decrease) increase in cash and cash equivalents | (260,960)  | 300,693    | 695       |
| Cash and cash equivalents, beginning of year         | 373,565    | 72,872     | 72,177    |
| Cash and cash equivalents, end of year               | \$ 112,605 | \$ 373,565 | \$ 72,872 |

Supplemental disclosures of cash flow information:

|   |          |          |          |
|---|----------|----------|----------|
| Interest paid   | \$ 2,685 | \$ 4,694 | \$ 7,901 |
| Income taxes paid   | 2,021    | 2,730    | 490      |
| Supplemental schedule of non-cash investing activity:           |          |          |          |
| Due to broker for securities purchased, settling after year-end | \$ 961   | \$ 3,493 | \$ 5,175 |
| Transfer of loans held-for-sale to loan portfolio               | 3,770    | 87       | 235      |
| Transfer securities from available-for-sale to held-to-maturity |          | 15,498   |          |
| Loans transferred to foreclosed assets                          | 33       | 2,056    | 4,565    |

See notes to consolidated financial statements

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**HERITAGE COMMERCE CORP**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(1) Summary of Significant Accounting Policies**

*Description of Business and Basis of Presentation*

Heritage Commerce Corp ("HCC") operates as a registered bank holding company for its wholly-owned subsidiary Heritage Bank of Commerce ("HBC" or the "Bank"), collectively referred to as the "Company". HBC was incorporated on November 23, 1993 and commenced operations on June 8, 1994. HBC is a California state chartered bank which offers a full range of commercial and personal banking services to residents and the business/professional community in Santa Clara, Alameda, and Contra Costa counties, California.

The consolidated financial statements are prepared in accordance with accounting policies generally accepted in the United States of America and general practices in the banking industry. The financial statements include the accounts of the Company. All inter-company accounts and transactions have been eliminated in consolidation.

The Company also established the following wholly-owned Delaware business trusts that were formed to issue trust preferred and related common securities: Heritage Capital Trust I and Heritage Statutory Trust I, formed in 2000, Heritage Statutory Trust II, formed in 2001, and Heritage Statutory Trust III, formed in 2002 ("Trusts"). During the third quarter of 2012 the Company dissolved the Heritage Statutory Trust I and the Heritage Capital Trust I. During the third quarter of 2013, the Company dissolved the Heritage Statutory Trust II and the Heritage Statutory Trust III.

The Trusts issued their preferred securities to investors, and used the proceeds to purchase subordinated debt issued by the Company. The subordinated debt payable to the Trusts was recorded as debt of the Company. The Company had fully and unconditionally guaranteed the trust preferred securities along with all obligations of the Trusts under the trust agreements. Interest income from the subordinated debt was the source of revenues for these Trusts. In accordance with generally accepted accounting principles, the Trusts were not consolidated in the Company's financial statements.

*Use of Estimates*

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The allowance for loan losses, carrying value of foreclosed assets, deferred tax assets and liabilities, intangible assets, loan servicing rights, interest-only strip receivables, defined benefit pension and split-dollar life insurance benefit plan and the fair values of financial instruments are particularly subject to change.

*Cash and Cash Equivalents*

Cash and cash equivalents include cash on hand, amounts due from banks, amounts held at the Federal Reserve Bank, and Federal funds sold. The Company is required to maintain reserves against certain of the deposit accounts with the Federal Reserve Bank. Federal funds are generally sold and purchased for one-day periods.

*Cash Flows*

Net cash flows are reported for customer loan and deposit transactions, notes payable, repurchase agreements and other short-term borrowings.

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**HERITAGE COMMERCE CORP**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

*Securities*

The Company classifies its securities as either available-for-sale or held-to-maturity at the time of purchase. Debt securities are classified as held-to-maturity and carried at amortized cost when management has the positive intent and ability to hold them to maturity. Debt securities not classified as held-to-maturity are classified as available-for-sale. Securities available-for-sale are carried at fair value, with unrealized holding gains and losses reported in other comprehensive income, net of taxes.

A decline in the fair value of any available-for-sale or held-to-maturity security below amortized cost that is deemed other than temporary results in a charge to earnings and the corresponding establishment of a new cost basis for the security. In estimating other-than-temporary losses, management considers (1) the length of time and extent that fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the fair value decline was affected by macroeconomic conditions, and (4) whether the Company has the intention to sell the security or more likely than not will be required to sell the security before any anticipated recovery in fair value.

Interest income includes amortization of purchase premiums or discounts. Premiums and discounts are amortized, or accreted, over the life of the related security as an adjustment to income using a method that approximates the interest method. Realized gains and losses are recorded on the trade date and determined using the specific identification method for the cost of securities sold.

*Loan Sales and Servicing*

The Company holds for sale the conditionally guaranteed portion of certain loans guaranteed by the Small Business Administration or the U.S. Department of Agriculture (collectively referred to as "SBA loans"). These loans are carried at the lower of aggregate cost or fair value. Net unrealized losses, if any, are recorded as a valuation allowance and charged to earnings.

Gains or losses on SBA loans held-for-sale are recognized upon completion of the sale, based on the difference between the net sales proceeds and the relative fair value of the guaranteed portion of the loan sold compared to the relative fair value of the unguaranteed portion.

SBA loans are sold with servicing retained. Servicing assets recognized separately upon the sale of SBA loans consist of servicing rights and, for loans sold prior to 2009, interest-only strip receivables ("I/O strips"). The Company accounts for the sale and servicing of SBA loans based on the financial and servicing assets it controls and liabilities it has incurred, reversing recognition of financial assets when control has been surrendered, and reversing recognition of liabilities when extinguished. Servicing rights are initially recorded at fair value with the income statement effect recorded in gains on sale of loans. Servicing rights are amortized in proportion to and over the period of net servicing income and are assessed for impairment on an ongoing basis. Impairment is determined by stratifying the servicing rights based on interest rates and terms. Any servicing assets in excess of the contractually specified servicing fees are reclassified at fair value as an I/O strip receivable and treated like an available for sale security. Fair value is determined using prices for similar assets with similar characteristics, when available, or based upon discounted cash flows using market-based assumptions. Impairment is recognized through a valuation allowance. The servicing rights, net of any required valuation allowance, and I/O strip receivable are included in other assets on the consolidated balance sheets.

Servicing income, net of amortization of servicing rights, is recognized as noninterest income. The initial fair value of I/O strip receivables is amortized against interest income on loans.

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**HERITAGE COMMERCE CORP**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

***Loans***

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are stated at the principal amount outstanding, net of deferred loan origination fees and costs and an allowance for loan losses. The majority of the Company's loans have variable interest rates. Interest on loans is accrued on the unpaid principal balance and is credited to income using the effective yield interest method.

A loan portfolio segment is defined as the level at which the Company uses a systematic methodology to determine the allowance for loan losses. A loan portfolio class is defined as a group of loans having similar risk characteristics and methods for monitoring and assessing risk.

For all loan classes, when a loan is classified as nonaccrual, the accrual of interest is discontinued, any accrued and unpaid interest is reversed, and the amortization of deferred loan fees and costs is discontinued. For all loan classes, loans are classified as nonaccrual when the payment of principal or interest is 90 days past due, unless the loan is well secured and in the process of collection. Nonaccrual loans and loans past due 90 days still on accrual include both smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans. In certain circumstances, loans that are under 90 days past due may also be classified as nonaccrual. Any interest or principal payments received on nonaccrual loans are applied toward reduction of principal. Nonaccrual loans generally are not returned to performing status until the obligation is brought current, the loan has performed in accordance with the contract terms for a reasonable period of time, and the ultimate collectability of the contractual principal and interest is no longer in doubt.

Non-refundable loan fees and direct origination costs are deferred and recognized over the expected lives of the related loans using the effective yield interest method.

***Allowance for Loan Losses***

The allowance for loan losses is an estimate of probable incurred losses in the loan portfolio. Loans are charged-off against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance for loan losses. Management's methodology for estimating the allowance balance consists of several key elements, which include specific allowances on individual impaired loans and the formula driven allowances on pools of loans with similar risk characteristics. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management's judgment, should be charged off.

Specific allowances are established for impaired loans. Management considers a loan to be impaired when it is probable that the Company will be unable to collect all amounts due according to the original contractual terms of the loan agreement, including scheduled interest payments. Loans for which the terms have been modified with a concession granted, and for which the borrower is experiencing financial difficulties, are considered troubled debt restructurings and classified as impaired. When a loan is considered to be impaired, the amount of impairment is measured based on the fair value of the collateral, less costs to sell, if the loan is collateral dependent, or on the present value of expected future cash flows or values that are observable in the secondary market if the loan is not collateral dependent. The amount of any impairment will be charged off against the allowance for loan losses if the amount is a confirmed loss or, alternatively, a specific allocation within the allowance will be established. Loans that are considered impaired are specifically excluded from the formula portion of the allowance for loan losses analysis.

The formula driven allowance on pools of loans covers all loans that are not impaired and is based on historical losses of each loan segment adjusted for current factors. In calculating the historical component

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**HERITAGE COMMERCE CORP**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

of our allowance, we aggregate our loans into one of three loan segments: Commercial, Real Estate and Consumer. Each segment of loans in the portfolio possess varying degrees of risk, based on, among other things, the type of loan being made, the purpose of the loan, the type of collateral securing the loan, and the sensitivity the borrower has to changes in certain external factors such as economic conditions. The following provides a summary of the risks associated with various segments of the Company's loan portfolio, which are factors management regularly considers when evaluating the adequacy of the allowance:

Commercial loans consist primarily of commercial and industrial loans (business lines of credit), and other commercial purpose loans. Repayment of commercial and industrial loans is generally provided from the cash flows of the related business to which the loan was made. Adverse changes in economic conditions may result in a decline in business activity, which may impact a borrower's ability to continue to make scheduled payments.

Real estate loans consist primarily of loans secured by commercial and residential real estate. Also included in this segment are land and construction loans and home equity lines of credit secured by real estate. As the majority of this segment is comprised of commercial real estate loans, risks associated with this segment lay primarily within these loan types. Adverse economic conditions may result in a decline in business activity and increased vacancy rates for commercial properties. These factors, in conjunction with a decline in real estate prices, may expose the Company to the potential for losses if a borrower cannot continue to service the loan with operating revenues, and the value of the property has declined to a level such that it no longer fully covers the Company's recorded investment in the loan.

Consumer loans consist primarily of a large number of small loans and lines of credit. The majority of installment loans are made for consumer and business purchases. Weakened economic conditions may result in an increased level of delinquencies within this segment, as economic pressures may impact the capacity of such borrowers to repay their obligations.

As a result of the matters mentioned above, changes in the financial condition of individual borrowers, economic conditions, historical loss experience and the condition of the various markets in which collateral may be sold may all affect the required level of the allowance for loan losses and the associated provision for loan losses.

The estimated loss factors for pools of loans that are not impaired are based on determining the probability of default and loss given default for loans within each segment of the portfolio, adjusted for significant factors that, in management's judgment, affect collectibility as of the evaluation date. The Company's historical delinquency experience and loss experience are utilized to determine the probability of default and loss given default for segments of the portfolio where the Company has experienced losses in the past. For segments of the portfolio where the Company has no significant prior loss experience, the Company uses quantifiable observable industry data to determine the probability of default and loss given default. Risk factors impacting loans in each of the portfolio segments include broad deterioration of property values, reduced consumer and business spending as a result of continued high unemployment and reduced credit availability and lack of confidence in a sustainable recovery. The historical loss experience is adjusted for management's estimate of the impact of other factors based on the risks present for each portfolio segment. These other factors include consideration of the following: the overall level of concentrations and trends of classified loans; loan concentrations within a portfolio segment or division of a portfolio segment; identification of certain loan types with higher risk than other loans; existing internal risk factors; and management's evaluation of the impact of local and national economic conditions on each of our loan types.

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**HERITAGE COMMERCE CORP**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

***Loan Commitments and Related Financial Instruments***

Financial instruments include off-balance sheet credit instruments, such as commitments to make loans and commercial letters of credit, issued to meet customer financing needs. The face amount for these items represents the exposure to loss, before considering customer collateral or ability to repay. Such financial instruments are recorded when they are funded.

***Federal Home Loan Bank and Federal Reserve Bank Stock***

As a member of the Federal Home Loan Bank ("FHLB") system, the Bank is required to own common stock in the FHLB based on the Bank's level of borrowings and outstanding FHLB advances. FHLB stock is carried at cost and classified as a restricted security. Both cash and stock dividends are reported as income.

As a member of the Federal Reserve Bank ("FRB") of San Francisco, the Bank is required to own stock in the FRB of San Francisco based on a specified ratio relative to our capital. FRB stock is carried at cost and may be sold back to the FRB at its carrying value. Cash dividends received are reported as income.

***Company Owned Life Insurance and Split-Dollar Life Insurance Benefit Plan***

The Company has purchased life insurance policies on certain directors and officers. Company owned life insurance is recorded at the amount that can be realized under the insurance contract at the balance sheet date, which is the cash surrender value adjusted for other charges or other amounts due that are probable at settlement. The purchased insurance is subject to split-dollar insurance agreements with the insured participants, which continues after the participant's employment and retirement.

Accounting guidance requires that a liability be recorded over the average life expectancy when a split-dollar life insurance agreement continues after a participant's employment or retirement. The required accrued liability is based on either the post-employment benefit cost for the continuing life insurance or the future death benefit depending on the contractual terms of the underlying agreement.

***Premises and Equipment***

Land is carried at cost. Premises and equipment are stated at cost. Depreciation and amortization are computed on the straight-line basis over the lesser of the respective lease terms or estimated useful lives. The Company owns one building which is being depreciated over 40 years. Furniture, equipment, and leasehold improvements are depreciated over estimated useful lives generally ranging from five to fifteen years. The Company evaluates the recoverability of long-lived assets on an ongoing basis.

***Intangible Assets***

Intangible assets consist of core deposit and customer relationship intangible assets arising from the 2007 Diablo Valley Bank acquisition. They are initially measured at fair value and then are amortized on an accelerated method over their estimated useful lives. The core deposits and customer relationship intangible assets are being amortized over ten and seven years, respectively.

***Foreclosed Assets***

Assets acquired through or instead of loan foreclosure are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. If fair value declines subsequent to foreclosure, a



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**HERITAGE COMMERCE CORP**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

valuation allowance is recorded through operations. Operating costs after acquisition are expensed. Gains and losses on disposition are included in noninterest expense.

The carrying value of foreclosed assets was \$575,000 and \$1,270,000 at December 31, 2013 and 2012, respectively, and is included in other assets on the consolidated balance sheets.

***Retirement Plans***

Expenses for the Company's non-qualified, unfunded defined benefits plan consists of service and interest cost and amortization of gains and losses not immediately recognized. Employee 401(k) and profit sharing plan expense is the amount of matching contributions. Deferred compensation and supplemental retirement plan expense allocates the benefits over years of service.

***Loss Contingencies***

Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. The Company's accounting policy for legal costs related to loss contingencies is to accrue for the probable fees that can be reasonably estimated. The Company's accounting policy for uncertain recoveries is to recognize the anticipated recovery when realization is deemed probable.

***Income Taxes***

The Company files consolidated Federal and combined state income tax returns. Income tax expense is the total of the current year income tax payable or refund and the change in deferred tax assets and liabilities. Some items of income and expense are recognized in different years for tax purposes when applying generally accepted accounting principles, leading to timing differences between the Company's actual tax liability and the amount accrued for this liability based on book income. These temporary differences comprise the "deferred" portion of the Company's tax expense or benefit, which is accumulated on the Company's books as a deferred tax asset or deferred tax liability until such time as they reverse.

Realization of the Company's deferred tax assets is primarily dependent upon the Company generating sufficient taxable income to obtain benefit from the reversal of net deductible temporary differences and utilization of tax credit carryforwards and the net operating loss carryforwards for Federal and California state income tax purposes. The amount of deferred tax assets considered realizable is subject to adjustment in future periods based on estimates of future taxable income. Under generally accepted accounting principles, a valuation allowance is required to be recognized if it is "more likely than not" that a deferred tax asset will not be realized. The determination of the realizability of the deferred tax assets is highly subjective and dependent upon judgment concerning management's evaluation of both positive and negative evidence, including forecasts of future income, cumulative losses, applicable tax planning strategies, and assessments of current and future economic and business conditions.

The Company had net deferred tax assets of \$23,326,000 and \$19,264,000 at December 31, 2013, and December 31, 2012, respectively. After consideration of the matters in the preceding paragraph, the Company determined that it is more likely than not that the net deferred tax asset at December 31, 2013 and 2012 will be fully realized in future years.

A tax position is recognized as a benefit only if it is "more likely than not" that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the "more likely than not" test, no tax benefit is recorded. The Company recognizes interest and penalties related to uncertain tax positions as income tax expense.

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**HERITAGE COMMERCE CORP**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

***Stock-Based Compensation***

Compensation cost is recognized for stock options and restricted stock awards issued to employees, based on the fair value of these awards at the date of grant. A Black-Scholes model is utilized to estimate the fair value of stock options, while the market price of the Company's common stock at the date of grant is used for restricted stock awards. Compensation cost is recognized over the required service period, generally defined as the vesting period. For awards with graded vesting, compensation cost is recognized on a straight-line basis over the requisite service period for the entire award. Compensation cost recognized reflects estimated forfeitures, adjusted as necessary for actual forfeitures.

***Comprehensive Income (Loss)***

Comprehensive income (loss) consists of net income (loss) and other comprehensive income (loss). Other comprehensive income (loss) refers to gains and losses that are included in comprehensive income (loss) but are excluded from net income (loss) because they have been recorded directly in equity under the provisions of certain accounting guidance. The Company's sources of other comprehensive income (loss) are unrealized gains and losses on securities available-for-sale, and I/O strips, which are treated like available-for-sale securities, and the liabilities related to the Company's defined benefit pension plan and the split-dollar life insurance benefit plan. Reclassification adjustments result from gains or losses on securities that were realized and included in net income (loss) of the current period that also had been included in other comprehensive income as unrealized holding gains and losses.

***Segment Reporting***

HBC is an independent community business bank with ten branch offices that offer similar products to customers. No customer accounts for more than 10 percent of revenues for HBC or the Company. While the chief decision-makers monitor the revenue streams of the various products and services, operations are managed and financial performance is evaluated on a Company wide basis. Management evaluates the Company's performance as a whole and does not allocate resources based on the performance of different lending or transaction activities. Accordingly, the Company and its subsidiary bank all operate as one business segment.

***Reclassifications***

Certain items in the consolidated financial statements for the years ended December 31, 2012 and 2011 were reclassified to conform to the 2013 presentation. These reclassifications did not affect previously reported net income.

***Adoption of New Accounting Standards***

In February 2013, the FASB issued an accounting standards update with the primary objective of improving the reporting of reclassifications out of accumulated other comprehensive income ("AOCI"). For significant reclassifications that are required to be presented in their entirety in net income in the same reporting period by U.S. GAAP, the update requires an entity to report the effect of these reclassifications out of AOCI on the respective line items of net income either on the face of the statement that reports net income or in the financial statement notes. For AOCI items that are not reclassified to net income in their entirety, presentation in the financial statement notes is required. This update is effective for public companies for fiscal years and interim periods within those years beginning after December 15, 2012, or the first quarter of 2013 for calendar year-end companies, and is required to be applied prospectively. The effect of adopting this standard did not have a material effect on the Company's operating results or financial condition, but the additional disclosures are included in Note 2.

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## HERITAGE COMMERCE CORP

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## (2) Accumulated Other Comprehensive Income ("AOCI")

The following table reflects the changes in AOCI by component for the periods indicated:

|   | For the Years Ended December 31, 2013, 2012, and 2011   |  |   |            | Total(1) |
|---|---|--|---|------------|----------|
|   | Unrealized<br>Gains (Losses) on<br>Available-<br>for-Sale<br>Securities<br>and I/O<br>Strips(1) | Unamortized<br>Unrealized<br>Gain on<br>Available-<br>for-Sale<br>Securities<br>Reclassified<br>to Held-to-<br>Maturity(1) | Defined<br>Benefit<br>Pension<br>Plan<br>Items(1) |            |          |
|   | (Dollars in thousands)  |  |   |            |          |
| Beginning balance January 1, 2013, net of taxes                           | \$ 7,887  | \$ 497   | \$ (5,703)  | \$ 2,681   |          |
| Other comprehensive (loss) before reclassification, net of taxes          | (8,295)   |  | 1,518   | (6,777)    |          |
| Amounts reclassified from other comprehensive income (loss), net of taxes | (22)  | (31)   | 120   | 67         |          |
| Net current period other comprehensive income (loss), net of taxes        | (8,317)   | (31)   | 1,638   | (6,710)    |          |
| Ending balance December 31, 2013, net of taxes                            | \$ (430)  | \$ 466   | \$ (4,065)  | \$ (4,029) |          |
| Beginning balance January 1, 2012, net of taxes                           | \$ 6,210  | \$   | \$ (5,255)  | \$ 955     |          |
| Other comprehensive income (loss) before reclassification, net of taxes   | 2,582   |  | (568)   | 2,014      |          |
| Amounts reclassified from other comprehensive income (loss), net of taxes | (905)   | 497  | 120   | (288)      |          |
| Net current period other comprehensive income, net of taxes               | 1,677   | 497  | (448)   | 1,726      |          |
| Ending balance December 31, 2012, net of taxes                            | \$ 7,887  | \$ 497   | \$ (5,703)  | \$ 2,681   |          |
| Beginning balance January 1, 2011, net of taxes                           | \$ (513)  | \$   | \$ (4,138)  | \$ (4,651) |          |
| Other comprehensive income (loss) before reclassification, net of taxes   | 6,989   |  | (1,285)   | 5,704      |          |
| Amounts reclassified from other comprehensive income (loss), net of taxes | (266)   |  | 168   | (98)       |          |
| Net current period other comprehensive income, net of taxes               | 6,723   |  | (1,117)   | 5,606      |          |

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|  |    |       |    |    |         |    |     |
|--|----|-------|----|----|---------|----|-----|
| Ending balance December 31, 2011, net of taxes | \$ | 6,210 | \$ | \$ | (5,255) | \$ | 955 |
|--|----|-------|----|----|---------|----|-----|

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(1) Amounts in parenthesis indicate debits.

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## HERITAGE COMMERCE CORP

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

| Details About AOCI Components  | Amounts Reclassified from<br>AOCI(1)<br>For the Year Ended<br>December 31, |                   |                 | Affected Line Item Where<br>Net Income is Presented         |
|--|--|-------------------|-----------------|---|
|  | 2013   | 2012              | 2011            |   |
|  | (Dollars in thousands)   |                   |                 |   |
| Unrealized gains on available-for-sale securities<br>and I/O strips  | \$ 38<br>(16)  | \$ 1,560<br>(655) | \$ 459<br>(193) | Realized gains on sale of securities<br>Income tax expense  |
|  | 22   | 905               | 266             | Net of tax  |
| Amortization of unrealized gain on securities<br>available-for-sale that were reclassified to securities<br>held-to-maturity | 54<br>(23)   | (857)<br>360      |                 | Interest income on taxable securities<br>Income tax expense |
|  | 31   | (497)             |                 | Net of tax  |
| Amortization of defined benefit pension plan<br>items(2)   |  |                   |                 |   |
| Prior service cost   |  | (27)              | (36)            |   |
| Prior transition obligation  | 84   | 73                | (130)           |   |
| Actuarial losses   | (291)  | (253)             | (123)           |   |
|  | (207)  | (207)             | (289)           | Income before income tax                                    |
|  | 87   | 87                | 121             | Income tax expense  |
|  | (120)  | (120)             | (168)           | Net of tax  |
| Total reclassification for the year  | \$ (67)  | \$ 288            | \$ 98           |   |

(1) Amounts in parenthesis indicate debits.

(2) This AOCI component is included in the computation of net periodic benefit cost (see Note 12 Benefit Plans).



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## HERITAGE COMMERCE CORP

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## (3) Securities

The amortized cost and estimated fair value of securities at year-end were as follows:

| 2013                              | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>(Losses) | Estimated<br>Fair<br>Value |
|-----------------------------------|-------------------|------------------------------|---------------------------------|----------------------------|
| (Dollars in thousands)            |                   |                              |                                 |                            |
| Securities available-for-sale:    |                   |                              |                                 |                            |
| Agency mortgage-backed securities | \$ 208,644        | \$ 2,465                     | \$ (3,465)                      | \$ 207,644                 |
| Corporate bonds                   | 53,002            | 527                          | (1,483)                         | 52,046                     |
| Trust preferred securities        | 20,849            |                              | (439)                           | 20,410                     |
| <b>Total</b>                      | <b>\$ 282,495</b> | <b>\$ 2,992</b>              | <b>\$ (5,387)</b>               | <b>\$ 280,100</b>          |

Securities held-to-maturity:

|                                   |                  |              |                   |                  |
|-----------------------------------|------------------|--------------|-------------------|------------------|
| Agency mortgage-backed securities | \$ 15,932        | \$           | \$ (470)          | \$ 15,462        |
| Municipals tax exempt             | 79,989           | 54           | (9,473)           | 70,570           |
| <b>Total</b>                      | <b>\$ 95,921</b> | <b>\$ 54</b> | <b>\$ (9,943)</b> | <b>\$ 86,032</b> |

| 2012                              | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>(Losses) | Estimated<br>Fair<br>Value |
|-----------------------------------|-------------------|------------------------------|---------------------------------|----------------------------|
| (Dollars in thousands)            |                   |                              |                                 |                            |
| Securities available-for-sale:    |                   |                              |                                 |                            |
| Agency mortgage-backed securities | \$ 281,598        | \$ 9,668                     | \$ (22)                         | \$ 291,244                 |
| Corporate bonds                   | 53,739            | 1,849                        |                                 | 55,588                     |
| Trust preferred securities        | 20,769            | 375                          | (64)                            | 21,080                     |
| <b>Total</b>                      | <b>\$ 356,106</b> | <b>\$ 11,892</b>             | <b>\$ (86)</b>                  | <b>\$ 367,912</b>          |

Securities held-to-maturity:

|                                   |           |      |         |           |
|-----------------------------------|-----------|------|---------|-----------|
| Agency mortgage-backed securities | \$ 16,659 | \$ 2 | \$ (68) | \$ 16,593 |
| Municipals tax exempt             | 34,813    | 80   | (413)   | 34,480    |

|       |    |        |    |    |    |       |    |        |
|-------|----|--------|----|----|----|-------|----|--------|
| Total | \$ | 51,472 | \$ | 82 | \$ | (481) | \$ | 51,073 |
|-------|----|--------|----|----|----|-------|----|--------|



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Securities with unrealized losses at year end, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, are as follows:

| 2013                                  | Less Than 12 Months |                     | 12 Months or More |                     | Total             |                     |
|---------------------------------------|---------------------|---------------------|-------------------|---------------------|-------------------|---------------------|
|                                       | Fair Value          | Unrealized (Losses) | Fair Value        | Unrealized (Losses) | Fair Value        | Unrealized (Losses) |
| (Dollars in thousands)                |                     |                     |                   |                     |                   |                     |
| <b>Securities available-for-sale:</b> |                     |                     |                   |                     |                   |                     |
| Agency mortgage-backed securities     | \$ 87,798           | \$ (2,869)          | \$ 8,920          | \$ (596)            | \$ 96,718         | \$ (3,465)          |
| Corporate bonds                       | 38,092              | (1,322)             | 1,860             | (161)               | 39,952            | (1,483)             |
| Trust preferred securities            | 20,410              | (439)               |                   |                     | 20,410            | (439)               |
| <b>Total</b>                          | <b>\$ 146,300</b>   | <b>\$ (4,630)</b>   | <b>\$ 10,780</b>  | <b>\$ (757)</b>     | <b>\$ 157,080</b> | <b>\$ (5,387)</b>   |

|                                     |                  |                   |                  |                   |                  |                   |
|-------------------------------------|------------------|-------------------|------------------|-------------------|------------------|-------------------|
| <b>Securities held-to-maturity:</b> |                  |                   |                  |                   |                  |                   |
| Agency mortgage-backed securities   | \$ 5,978         | \$ (101)          | \$ 9,134         | \$ (369)          | \$ 15,112        | \$ (470)          |
| Municipals Tax Exempt               | 38,177           | (4,421)           | 25,520           | (5,052)           | 63,697           | (9,473)           |
| <b>Total</b>                        | <b>\$ 44,155</b> | <b>\$ (4,522)</b> | <b>\$ 34,654</b> | <b>\$ (5,421)</b> | <b>\$ 78,809</b> | <b>\$ (9,943)</b> |

| 2012                                  | Less Than 12 Months |                     | 12 Months or More |                     | Total            |                     |
|---------------------------------------|---------------------|---------------------|-------------------|---------------------|------------------|---------------------|
|                                       | Fair Value          | Unrealized (Losses) | Fair Value        | Unrealized (Losses) | Fair Value       | Unrealized (Losses) |
| (Dollars in thousands)                |                     |                     |                   |                     |                  |                     |
| <b>Securities available-for-sale:</b> |                     |                     |                   |                     |                  |                     |
| Agency mortgage-backed securities     | \$ 6,226            | \$ (22)             | \$                | \$                  | \$ 6,226         | \$ (22)             |
| Trust preferred securities            | 5,705               | (64)                |                   |                     | 5,705            | (64)                |
| <b>Total</b>                          | <b>\$ 11,931</b>    | <b>\$ (86)</b>      | <b>\$</b>         | <b>\$</b>           | <b>\$ 11,931</b> | <b>\$ (86)</b>      |

|                                     |           |         |    |    |           |         |
|-------------------------------------|-----------|---------|----|----|-----------|---------|
| <b>Securities held-to-maturity:</b> |           |         |    |    |           |         |
|                                     | \$ 15,789 | \$ (68) | \$ | \$ | \$ 15,789 | \$ (68) |

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Agency mortgage-backed securities

| Municipals | Tax Exempt |        |       |        |       |
|------------|------------|--------|-------|--------|-------|
|            |            | 21,985 | (413) | 21,985 | (413) |

|       |  |           |          |           |          |
|-------|--|-----------|----------|-----------|----------|
| Total |  | \$ 37,774 | \$ (481) | \$ 37,774 | \$ (481) |
|-------|--|-----------|----------|-----------|----------|

There were no holdings of securities of any one issuer, other than the U.S. Government and its sponsored entities, in an amount greater than 10% of shareholders' equity. At December 31, 2013, the Company held 392 securities (163 available-for-sale and 229 held-to-maturity), of which 275 had fair values below amortized cost. At December 31, 2013, there were \$8.9 million of agency mortgage-backed securities available-for-sale, \$1.9 million of corporate bonds available-for-sale, \$9.1 million of agency mortgage-backed securities held-to-maturity, and \$25.5 million of municipal bonds held-to-maturity carried with an unrealized loss for over 12 months. The total unrealized loss for securities over 12 months was \$6.2 million at December 31, 2013. The unrealized losses were due to higher interest rates. The issuers are of high credit quality and all principal amounts are expected to be paid when securities mature. The fair value is expected to recover as the securities approach their maturity date and/or market rates decline. The Company does not believe that it is more likely than not that the Company will be required to sell a security in an unrealized loss position prior to recovery in value. The Company does not consider these securities to be other-than-temporarily impaired at December 31, 2013.

At December 31, 2012, the Company held 269 securities (168 available-for-sale and 101 held-to-maturity), of which 70 had fair values below amortized cost. No securities had been carried with an

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unrealized loss for over 12 months. Unrealized losses were due to higher interest rates. The Company did not consider these securities to be other-than-temporarily impaired at December 31, 2012.

The proceeds from sales of securities and the resulting gains and losses are listed below:

|              | 2013                   | 2012      | 2011      |
|--------------|------------------------|-----------|-----------|
|              | (Dollars in thousands) |           |           |
| Proceeds     | \$ 26,944              | \$ 40,587 | \$ 45,014 |
| Gross gains  | 310                    | 1,560     | 480       |
| Gross losses | (272)                  |           | (21)      |

The amortized cost and fair value of debt securities as of December 31, 2013, by contractual maturity, are shown below. The expected maturities will differ from contractual maturities if borrowers have the right to call or prepay obligations with or without call or prepayment penalties. Securities not due at a single maturity date are shown separately.

|                                   | Available-for-sale     |                         |
|-----------------------------------|------------------------|-------------------------|
|                                   | Amortized<br>Cost      | Estimated<br>Fair Value |
|                                   | (Dollars in thousands) |                         |
| Due after one through five years  | \$ 6,258               | \$ 6,618                |
| Due after five through ten years  | 46,744                 | 45,428                  |
| Due after ten years               | 20,849                 | 20,410                  |
| Agency mortgage-backed securities | 208,644                | 207,644                 |
| <b>Total</b>                      | <b>\$ 282,495</b>      | <b>\$ 280,100</b>       |

|                                   | Held-to-maturity       |                         |
|-----------------------------------|------------------------|-------------------------|
|                                   | Amortized<br>Cost      | Estimated<br>Fair Value |
|                                   | (Dollars in thousands) |                         |
| Due after one through five years  | \$ 1,229               | \$ 1,202                |
| Due after five through ten years  | 12,841                 | 12,581                  |
| Due after ten years               | 65,919                 | 56,787                  |
| Agency mortgage-backed securities | 15,932                 | 15,462                  |
| <b>Total</b>                      | <b>\$ 95,921</b>       | <b>\$ 86,032</b>        |

Securities with amortized cost of \$147,455,000 and \$117,574,000 as of December 31, 2013 and 2012 were pledged to secure public deposits and for other purposes as required or permitted by law or contract.



Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(4) Loans and Loan Servicing**

Loans at year-end were as follows:

|                             | 2013                   | 2012       |
|-----------------------------|------------------------|------------|
|                             | (Dollars in thousands) |            |
| Loans held-for-investment:  |                        |            |
| Commercial                  | \$ 393,074             | \$ 375,469 |
| Real estate:                |                        |            |
| Commercial and residential  | 423,288                | 354,934    |
| Land and construction       | 31,443                 | 22,352     |
| Home equity                 | 51,815                 | 43,865     |
| Consumer                    | 15,677                 | 15,714     |
| <br>                        |                        |            |
| Loans                       | 915,297                | 812,334    |
| Deferred loan fees, net     | (384)                  | (21)       |
| <br>                        |                        |            |
| Loans, net of deferred fees | 914,913                | 812,313    |
| Allowance for loan losses   | (19,164)               | (19,027)   |
| <br>                        |                        |            |
| Loans, net                  | \$ 895,749             | \$ 793,286 |

Changes in the allowance for loan losses were as follows:

|                                    | For the Year Ended December 31, 2013 |             |          |           |
|------------------------------------|--------------------------------------|-------------|----------|-----------|
|                                    | Commercial                           | Real Estate | Consumer | Total     |
|                                    | (Dollars in thousands)               |             |          |           |
| Balance, beginning of year         | \$ 12,866                            | \$ 6,034    | \$ 127   | \$ 19,027 |
| Charge-offs                        | (1,676)                              | (276)       |          | (1,952)   |
| Recoveries                         | 2,621                                | 283         | 1        | 2,905     |
| <br>                               |                                      |             |          |           |
| Net recoveries                     | 945                                  | 7           | 1        | 953       |
| Provision (credit) for loan losses | (1,278)                              | 507         | (45)     | (816)     |
| <br>                               |                                      |             |          |           |
| Balance, end of year               | \$ 12,533                            | \$ 6,548    | \$ 83    | \$ 19,164 |

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For the Year Ended December 31, 2012

|                                    | Commercial             | Real Estate | Consumer | Total     |
|------------------------------------|------------------------|-------------|----------|-----------|
|                                    | (Dollars in thousands) |             |          |           |
| Balance, beginning of year         | \$ 13,215              | \$ 7,338    | \$ 147   | \$ 20,700 |
| Charge-offs                        | (3,935)                | (1,528)     |          | (5,463)   |
| Recoveries                         | 776                    | 230         |          | 1,006     |
| Net charge-offs                    | (3,159)                | (1,298)     |          | (4,457)   |
| Provision (credit) for loan losses | 2,810                  | (6)         | (20)     | 2,784     |
| Balance, end of year               | \$ 12,866              | \$ 6,034    | \$ 127   | \$ 19,027 |

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|                                    | <b>Commercial</b>             | <b>Real Estate</b> | <b>Consumer</b> | <b>Total</b> |
|------------------------------------|-------------------------------|--------------------|-----------------|--------------|
|                                    | <b>(Dollars in thousands)</b> |                    |                 |              |
| Balance, beginning of year         | \$ 13,952                     | \$ 10,363          | \$ 889          | \$ 25,204    |
| Charge-offs                        | (7,559)                       | (3,356)            | (8)             | (10,923)     |
| Recoveries                         | 678                           | 1,269              | 3               | 1,950        |
| Net charge-offs                    | (6,881)                       | (2,087)            | (5)             | (8,973)      |
| Provision (credit) for loan losses | 6,144                         | (938)              | (737)           | 4,469        |
| Balance, end of year               | \$ 13,215                     | \$ 7,338           | \$ 147          | \$ 20,700    |

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment, based on the impairment method as follows at year-end:

|  | <b>December 31, 2013</b>      |                    |                  |                   |
|--|-------------------------------|--------------------|------------------|-------------------|
|  | <b>Commercial</b>             | <b>Real Estate</b> | <b>Consumer</b>  | <b>Total</b>      |
|  | <b>(Dollars in thousands)</b> |                    |                  |                   |
| <b>Allowance for loan losses:</b>                      |                               |                    |                  |                   |
| <b>Ending allowance balance attributable to loans:</b> |                               |                    |                  |                   |
| Individually evaluated for impairment                  | \$ 1,694                      | \$ 741             | \$ 21            | \$ 2,456          |
| Collectively evaluated for impairment                  | 10,839                        | 5,807              | 62               | 16,708            |
| <b>Total allowance balance</b>                         | <b>\$ 12,533</b>              | <b>\$ 6,548</b>    | <b>\$ 83</b>     | <b>\$ 19,164</b>  |
| <b>Loans:</b>  |                               |                    |                  |                   |
| Individually evaluated for impairment                  | \$ 4,906                      | \$ 6,790           | \$ 122           | \$ 11,818         |
| Collectively evaluated for impairment                  | 388,168                       | 499,756            | 15,555           | 903,479           |
| <b>Total loan balance</b>                              | <b>\$ 393,074</b>             | <b>\$ 506,546</b>  | <b>\$ 15,677</b> | <b>\$ 915,297</b> |

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December 31, 2012

Commercial      Real Estate      Consumer      Total  
(Dollars in thousands)

|   |                  |                 |               |                  |
|---|------------------|-----------------|---------------|------------------|
| Allowance for loan losses:                      |                  |                 |               |                  |
| Ending allowance balance attributable to loans: |                  |                 |               |                  |
| Individually evaluated for impairment           | \$ 1,963         | \$ 760          | \$ 17         | \$ 2,740         |
| Collectively evaluated for impairment           | 10,903           | 5,274           | 110           | 16,287           |
| <b>Total allowance balance</b>                  | <b>\$ 12,866</b> | <b>\$ 6,034</b> | <b>\$ 127</b> | <b>\$ 19,027</b> |

Loans:

|                                       |                   |                   |                  |                   |
|---------------------------------------|-------------------|-------------------|------------------|-------------------|
| Individually evaluated for impairment | \$ 10,161         | \$ 9,336          | \$ 147           | \$ 19,644         |
| Collectively evaluated for impairment | 365,308           | 411,815           | 15,567           | 792,690           |
| <b>Total loan balance</b>             | <b>\$ 375,469</b> | <b>\$ 421,151</b> | <b>\$ 15,714</b> | <b>\$ 812,334</b> |

The following table presents loans held-for-investment individually evaluated for impairment by class of loans as of December 31, 2013 and December 31, 2012. The recorded investment included in the



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following table represents loan principal net of any partial charge-offs recognized on the loans. The unpaid principal balance represents the recorded balance prior to any partial charge-offs.

|  | December 31, 2013              |                        |  | December 31, 2012              |                        |  |
|--|--------------------------------|------------------------|--|--------------------------------|------------------------|--|
|  | Unpaid<br>Principal<br>Balance | Recorded<br>Investment | Allowance<br>for Loan<br>Losses<br>Allocated | Unpaid<br>Principal<br>Balance | Recorded<br>Investment | Allowance<br>for Loan<br>Losses<br>Allocated |
| (Dollars in thousands)                   |                                |                        |  |                                |                        |  |
| With no related allowance recorded:      |                                |                        |  |                                |                        |  |
| Commercial                               | \$ 1,999                       | \$ 1,915               | \$   | \$ 7,829                       | \$ 6,978               | \$   |
| Real estate:                             |                                |                        |  |                                |                        |  |
| Commercial and residential               | 2,831                          | 2,831                  |  | 2,755                          | 2,741                  |  |
| Land and construction                    | 1,761                          | 1,761                  |  | 2,310                          | 2,223                  |  |
| Home Equity                              | 377                            | 377                    |  | 2,141                          | 2,141                  |  |
| Total with no related allowance recorded |                                |                        |  |                                |                        |  |
|  | 6,968                          | 6,884                  |  | 15,035                         | 14,083                 |  |
| With an allowance recorded:              |                                |                        |  |                                |                        |  |
| Commercial                               | 3,225                          | 2,991                  | 1,694  | 3,678                          | 3,182                  | 1,963  |
| Real estate:                             |                                |                        |  |                                |                        |  |
| Commercial and residential               | 1,531                          | 1,531                  | 451  | 3,183                          | 1,937                  | 465  |
| Land and construction                    |                                |                        |  |                                |                        |  |
| Home Equity                              | 290                            | 290                    | 290  | 295                            | 295                    | 295  |
| Consumer                                 | 122                            | 122                    | 21   | 147                            | 147                    | 17   |
| Total with an allowance recorded         |                                |                        |  |                                |                        |  |
|  | 5,168                          | 4,934                  | 2,456  | 7,303                          | 5,561                  | 2,740  |
| Total                                    |                                |                        |  |                                |                        |  |
|  | \$ 12,136                      | \$ 11,818              | \$ 2,456                                     | \$ 22,338                      | \$ 19,644              | \$ 2,740                                     |

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following table presents interest recognized and cash-basis interest earned on impaired loans for the periods indicated:

|   | For the Year Ended December 31, 2013 |                                  |                          |                |          |           |
|---|--------------------------------------|----------------------------------|--------------------------|----------------|----------|-----------|
|   | Real Estate                          |                                  |                          |                |          | Total     |
|   | Commercial                           | Commercial<br>and<br>Residential | Land and<br>Construction | Home<br>Equity | Consumer |           |
|   | (Dollars in thousands)               |                                  |                          |                |          |           |
| Average of impaired loans during the period | \$ 6,855                             | \$ 4,921                         | \$ 2,028                 | \$ 2,064       | \$ 135   | \$ 16,003 |
| Interest income during impairment           | \$                                   | \$                               | \$                       | \$             | \$       | \$        |
| Cash-basis interest earned                  | \$                                   | \$                               | \$                       | \$             | \$       | \$        |

|   | For the Year Ended December 31, 2012 |                                  |                          |                |          |           |
|---|--------------------------------------|----------------------------------|--------------------------|----------------|----------|-----------|
|   | Real Estate                          |                                  |                          |                |          | Total     |
|   | Commercial                           | Commercial<br>and<br>Residential | Land and<br>Construction | Home<br>Equity | Consumer |           |
|   | (Dollars in thousands)               |                                  |                          |                |          |           |
| Average of impaired loans during the period | \$ 11,068                            | \$ 3,376                         | \$ 2,536                 | \$ 712         | \$ 96    | \$ 17,788 |
| Interest income during impairment           | \$                                   | \$ 1                             | \$ 14                    | \$             | \$       | \$ 15     |
| Cash-basis interest earned                  | \$                                   | \$ 1                             | \$ 14                    | \$             | \$       | \$ 15     |

Nonperforming loans include both smaller dollar balance homogenous loans that are collectively evaluated for impairment and individually classified loans. Nonperforming loans were as follows at year-end:

|   | 2013                   | 2012             |
|---|------------------------|------------------|
|   | (Dollars in thousands) |                  |
| Nonaccrual loans held-for-investment                            | \$ 11,326              | \$ 17,335        |
| Restructured and loans over 90 days past due and still accruing | 492                    | 859              |
| <b>Total nonperforming loans</b>                                | <b>\$ 11,818</b>       | <b>\$ 18,194</b> |

|   |           |           |
|---|-----------|-----------|
| Other restructured loans                      | \$        | \$ 1,450  |
| Impaired loans, excluding loans held-for-sale | \$ 11,818 | \$ 19,644 |

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following table presents the nonperforming loans by class at year-end:

|                            | 2013             |   |                  | 2012             |   |                  |
|----------------------------|------------------|---|------------------|------------------|---|------------------|
|                            | Nonaccrual       | Restructured and<br>Loans over 90<br>Days Past<br>Due and<br>Still Accruing | Total            | Nonaccrual       | Restructured and<br>Loans over 90<br>Days<br>Past Due and<br>Still Accruing | Total            |
| (Dollars in thousands)     |                  |   |                  |                  |   |                  |
| Commercial                 | \$ 4,414         | \$ 492  | \$ 4,906         | \$ 7,852         | \$ 859  | \$ 8,711         |
| Real estate:               |                  |   |                  |                  |   |                  |
| Commercial and residential | 4,363            |   | 4,363            | 4,676            |   | 4,676            |
| Land and construction      | 1,761            |   | 1,761            | 2,223            |   | 2,223            |
| Home equity                | 666              |   | 666              | 2,437            |   | 2,437            |
| Consumer                   | 122              |   | 122              | 147              |   | 147              |
| <b>Total</b>               | <b>\$ 11,326</b> | <b>\$ 492</b>   | <b>\$ 11,818</b> | <b>\$ 17,335</b> | <b>\$ 859</b>   | <b>\$ 18,194</b> |

The following table presents the aging of past due loans as of December 31, 2013 by class of loans:

|                            | 30 - 59<br>Days<br>Past Due | 60 - 89<br>Days<br>Past Due | 90 Days or<br>Greater<br>Past Due | Total<br>Past Due | Loans Not<br>Past Due | Total             |
|----------------------------|-----------------------------|-----------------------------|-----------------------------------|-------------------|-----------------------|-------------------|
|                            | (Dollars in thousands)      |                             |                                   |                   |                       |                   |
| Commercial                 | \$ 3,314                    | \$ 428                      | \$ 2,865                          | \$ 6,607          | \$ 386,467            | \$ 393,074        |
| Real estate:               |                             |                             |                                   |                   |                       |                   |
| Commercial and residential | 1,559                       |                             | 1,065                             | 2,624             | 420,664               | 423,288           |
| Land and construction      |                             |                             |                                   |                   | 31,443                | 31,443            |
| Home equity                | 28                          |                             | 290                               | 318               | 51,497                | 51,815            |
| Consumer                   |                             |                             | 89                                | 89                | 15,588                | 15,677            |
| <b>Total</b>               | <b>\$ 4,901</b>             | <b>\$ 428</b>               | <b>\$ 4,309</b>                   | <b>\$ 9,638</b>   | <b>\$ 905,659</b>     | <b>\$ 915,297</b> |

The following table presents the aging of past due loans as of December 31, 2012 by class of loans:

|            | 30 - 59<br>Days<br>Past Due | 60 - 89<br>Days<br>Past Due | 90 Days or<br>Greater<br>Past Due | Total<br>Past Due | Loans Not<br>Past Due | Total      |
|------------|-----------------------------|-----------------------------|-----------------------------------|-------------------|-----------------------|------------|
|            | (Dollars in thousands)      |                             |                                   |                   |                       |            |
| Commercial | \$ 1,699                    | \$ 355                      | \$ 5,120                          | \$ 7,174          | \$ 368,295            | \$ 375,469 |

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Real estate:

|                            |       |       |       |         |         |
|----------------------------|-------|-------|-------|---------|---------|
| Commercial and residential | 1,603 | 3,290 | 4,893 | 350,041 | 354,934 |
| Land and construction      |       | 78    | 78    | 22,274  | 22,352  |
| Home equity                | 742   | 2,045 | 2,787 | 41,078  | 43,865  |
| Consumer                   |       |       |       | 15,714  | 15,714  |

|       |          |        |           |           |            |            |
|-------|----------|--------|-----------|-----------|------------|------------|
| Total | \$ 4,044 | \$ 355 | \$ 10,533 | \$ 14,932 | \$ 797,402 | \$ 812,334 |
|-------|----------|--------|-----------|-----------|------------|------------|

Past due loans 30 days or greater totaled \$9,638,000 and \$14,932,000 at December 31, 2013 and December 31, 2012, respectively, of which \$5,900,000 and \$12,020,000 were on nonaccrual. At December 31, 2013, there were also \$5,426,000 loans less than 30 days past due included in nonaccrual loans held-for-investment. At December 31, 2012, there were also \$5,315,000 loans less than 30 days past

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**HERITAGE COMMERCE CORP**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

due included in nonaccrual loans held-for-investment. Management's classification of a loan as "nonaccrual" is an indication that there is reasonable doubt as to the full recovery of principal or interest on the loan. At that point, the Company stops accruing interest income, and reverses any uncollected interest that had been accrued as income. The Company begins recognizing interest income only as cash interest payments are received and it has been determined the collection of all outstanding principal is not in doubt. The loans may or may not be collateralized, and collection efforts are pursued.

***Credit Quality Indicators***

Concentrations of credit risk arise when a number of clients are engaged in similar business activities, or activities in the same geographic region, or have similar features that would cause their ability to meet contractual obligations to be similarly affected by changes in economic conditions. The Company's loan portfolio is concentrated in commercial (primarily manufacturing, wholesale, and service) and real estate lending, with the balance in consumer loans. While no specific industry concentration is considered significant, the Company's lending operations are located in the Company's market areas that are dependent on the technology and real estate industries and their supporting companies. Thus, the Company's borrowers could be adversely impacted by a continued downturn in these sectors of the economy which could reduce the demand for loans and adversely impact the borrowers' ability to repay their loans.

The Company categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information; historical payment experience; credit documentation; public information; and current economic trends, among other factors. The Company analyzes loans individually by classifying the loans as to credit risk. This analysis is performed on a quarterly basis. Nonclassified loans generally include those loans that are expected to be repaid in accordance with contractual loans terms. Classified loans are those loans that are assigned a substandard, substandard-nonaccrual, or doubtful risk rating using the following definitions:

*Substandard.* Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

*Substandard-Nonaccrual.* Loans classified as substandard-nonaccrual are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any, and it is probable that the Company will not receive payment of the full contractual principal and interest. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected. In addition, the Company no longer accrues interest on the loan because of the underlying weaknesses.

*Doubtful.* Loans classified as doubtful have all the weaknesses inherent in those classified as 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.

*Loss.* Loans classified as loss are considered uncollectable or of so little value that their continuance as assets is not warranted. This classification does not necessarily mean that a loan has no recovery or salvage value; but rather, there is much doubt about whether, how much, or when the recovery would occur. Loans classified as loss are immediately charged off against the allowance for loan losses. Therefore, there is no balance to report at December 31, 2013 or 2012.

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The following table provides a summary of the loan portfolio by loan type and credit quality classification for the periods indicated:

|                            | December 31, 2013 |                  |                   | December 31, 2012 |                  |                   |
|----------------------------|-------------------|------------------|-------------------|-------------------|------------------|-------------------|
|                            | Nonclassified     | Classified       | Total             | Nonclassified     | Classified       | Total             |
| (Dollars in thousands)     |                   |                  |                   |                   |                  |                   |
| Commercial                 | \$ 380,806        | 12,268           | \$ 393,074        | \$ 355,440        | \$ 20,029        | \$ 375,469        |
| Real estate:               |                   |                  |                   |                   |                  |                   |
| Commercial and residential | 416,992           | 6,296            | 423,288           | 345,045           | 9,889            | 354,934           |
| Land and construction      | 29,682            | 1,761            | 31,443            | 18,858            | 3,494            | 22,352            |
| Home equity                | 48,818            | 2,997            | 51,815            | 41,187            | 2,678            | 43,865            |
| Consumer                   | 15,336            | 341              | 15,677            | 15,321            | 393              | 15,714            |
| <b>Total</b>               | <b>\$ 891,634</b> | <b>\$ 23,663</b> | <b>\$ 915,297</b> | <b>\$ 775,851</b> | <b>\$ 36,483</b> | <b>\$ 812,334</b> |

In order to determine whether a borrower is experiencing financial difficulty, an evaluation is performed of the probability that the borrower will be in payment default on any of its debt in the foreseeable future without the modification. This evaluation is performed under the Company's underwriting policy.

For the year ended December 31, 2013, the terms of certain loans were modified as troubled debt restructurings. The modification of the terms of such loans included a reduction of the stated interest rate of the loan, or an extension of maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk.

The book balance of troubled debt restructurings at December 31, 2013 was \$3,722,000, which included \$3,230,000 of nonaccrual loans and \$492,000 of accruing loans. The book balance of troubled debt restructurings at December 31, 2012 was \$4,107,000, which included \$1,798,000 of nonaccrual loans and \$2,309,000 of accruing loans. Approximately \$1,186,000 and \$1,152,000 in specific reserves were established with respect to these loans as of December 31, 2013 and December 31, 2012. As of December 31, 2013 and December 31, 2012, the Company had no additional amounts committed on any loan classified as a troubled debt restructuring.

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following table presents loans by class modified as troubled debt restructurings during the twelve month period ended December 31, 2013 and 2012:

| Troubled Debt Restructurings:          | Number<br>of<br>Contracts | During the Year Ended<br>December 31, 2013                |  |
|--|---------------------------|---|--|
|  |                           | Pre-modification<br>Outstanding<br>Recorded<br>Investment | Post-modification<br>Outstanding<br>Recorded<br>Investment |
| (Dollars in thousands)                 |                           |   |  |
| Commercial                             | 1                         | \$ 211  | \$ 211   |
| Real Estate-Commercial and residential | 1                         | 1,531   | 1,531  |
| <b>Total</b>                           | <b>2</b>                  | <b>\$ 1,742</b>   | <b>\$ 1,742</b>  |

| Troubled Debt Restructurings: | Number<br>of<br>Contracts | During the Year Ended<br>December 31, 2012                |  |
|-------------------------------|---------------------------|---|--|
|                               |                           | Pre-modification<br>Outstanding<br>Recorded<br>Investment | Post-modification<br>Outstanding<br>Recorded<br>Investment |
| (Dollars in thousands)        |                           |   |  |
| Commercial                    | 2                         | \$ 87   | \$ 87  |
| Consumer                      | 1                         | 107   | 107  |
| <b>Total</b>                  | <b>3</b>                  | <b>\$ 194</b>   | <b>\$ 194</b>  |

The troubled debt restructurings described above increased the allowance for loan losses by \$491,000 and \$41,000 through the allocation of specific reserves, and resulted in no charge-offs for the years ended December 31, 2013 and 2012, respectively.

A loan is considered to be in payment default when it is 30 days contractually past due under the modified terms. There were no defaults on troubled debt restructurings within twelve months following the modification during the years ended December 31, 2013 and 2012.

At December 31, 2013 and 2012, the Company serviced SBA loans sold to the secondary market of approximately \$135,513,000 and \$150,192,000.

Servicing assets represent the servicing spread generated from the sold guaranteed portions of SBA loans. The weighted average servicing rate for all loans serviced was 1.34% and 1.33% at December 31, 2013 and 2012, respectively.

Servicing rights are included in "accrued interest receivable and other assets" on the consolidated balance sheets. Activity for loan servicing rights follows:

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|                            | 2013                   | 2012   | 2011   |
|----------------------------|------------------------|--------|--------|
|                            | (Dollars in thousands) |        |        |
| Balance, beginning of year | \$ 709                 | \$ 792 | \$ 915 |
| Additions                  | 106                    | 184    | 294    |
| Amortization               | (290)                  | (267)  | (417)  |
| Balance, end of year       | \$ 525                 | \$ 709 | \$ 792 |



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There was no valuation allowance for servicing rights at December 31, 2013 and 2012, because the estimated fair value of the servicing rights was greater than the carrying value. The estimated fair value of loan servicing rights was \$2,556,000 and \$2,929,000 at December 31, 2013 and 2012, respectively. The fair value of servicing rights at December 31, 2013, was estimated using a weighted average constant prepayment rate ("CPR") assumption of 6.83%, and a weighted average discount rate assumption of 13.55%. The fair value of servicing rights at December 31, 2012 was estimated using a weighted average constant prepayment rate ("CPR") assumption of 6.63%, and a weighted average discount rate assumption of 12.83%.

The weighted average discount rate and CPR assumptions used to estimate the fair value of the I/O strip receivables are the same as for the servicing rights. Management reviews the key economic assumptions used to estimate the fair value of I/O strip receivables on a quarterly basis. The fair value of the I/O strip can be adversely impacted by a significant increase in either the prepayment speed of the portfolio or the discount rate. At December 31, 2013, key economic assumptions and the sensitivity of the fair value of the I/O strip receivables to immediate 10% and 20% changes to the CPR assumption, and 1% and 2% changes to the discount rate assumption, are as follows:

|  | (Dollars in thousands) |       |
|--|------------------------|-------|
| Carrying amount/fair value of Interest-Only (I/O) strip                          | \$                     | 1,647 |
| Prepayment speed assumption (annual rate)  |                        | 6.8%  |
| Impact on fair value of 10% adverse change in prepayment speed (CPR 7.5%)        | \$                     | (34)  |
| Impact on fair value of 20% adverse change in prepayment speed (CPR 8.2%)        | \$                     | (68)  |
| Residual cash flow discount rate assumption (annual)                             |                        | 13.6% |
| Impact on fair value of 1% adverse change in discount rate (14.9% discount rate) | \$                     | (55)  |
| Impact on fair value of 2% adverse change in discount rate (16.3% discount rate) | \$                     | (106) |

I/O strip receivables are included in "accrued interest receivable and other assets" on the consolidated balance sheets. Activity for I/O strip receivables follows:

|                            | 2013                   | 2012     | 2011     |
|----------------------------|------------------------|----------|----------|
|                            | (Dollars in thousands) |          |          |
| Balance, beginning of year | \$ 1,786               | \$ 2,094 | \$ 2,140 |
| Amortization               |                        |          | (96)     |
| Unrealized gain (loss)     | (139)                  | (308)    | 50       |
| Balance, end of year       | \$ 1,647               | \$ 1,786 | \$ 2,094 |

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(5) Premises and Equipment**

Premises and equipment at year-end were as follows:

|   | 2013                   | 2012     |
|---|------------------------|----------|
|   | (Dollars in thousands) |          |
| Building                                  | \$ 3,256               | \$ 3,256 |
| Land                                      | 2,900                  | 2,900    |
| Furniture and equipment                   | 7,203                  | 7,074    |
| Leasehold improvements                    | 4,225                  | 4,668    |
|   | 17,584                 | 17,898   |
| Accumulated depreciation and amortization | (10,344)               | (10,429) |
| Premises and equipment, net               | \$ 7,240               | \$ 7,469 |

Depreciation and amortization expense was \$729,000, \$750,000, and \$766,000 in 2013, 2012, and 2011, respectively.

**(6) Leases***Operating Leases*

The Company owns one of its offices and leases the others under non-cancelable operating leases with terms, including renewal options, ranging from five to fifteen years. Future minimum payments under the agreements are as follows:

| Year ending December 31, | (Dollars in thousands) |
|--------------------------|------------------------|
| 2014                     | \$ 2,565               |
| 2015                     | 1,491                  |
| 2016                     | 885                    |
| 2017                     | 940                    |
| 2018                     | 228                    |
| Thereafter               | 114                    |
| Total                    | \$ 6,223               |

Rent expense under operating leases was \$2,719,000, \$2,735,000, and \$2,766,000 in 2013, 2012, and 2011, respectively.

**(7) Intangible Assets**

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Core deposit and customer relationship intangible assets acquired in the 2007 acquisition of Diablo Valley Bank were \$5,049,000 and \$276,000, respectively. These assets are amortized over their estimated useful lives. Accumulated amortization of these intangible assets was \$3,798,000 and \$3,325,000 at December 31, 2013 and 2012, respectively.

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Estimated amortization expense for each of the next four years follows:

|      | (Dollars in thousands) |     |
|------|------------------------|-----|
| 2014 | \$                     | 459 |
| 2015 |                        | 446 |
| 2016 |                        | 427 |
| 2017 |                        | 195 |

Impairment testing of the intangible assets is performed at the individual asset level. Impairment exists if the carrying amount of the asset is not recoverable and exceeds its fair value at the date of the impairment test. For intangible assets, estimates of expected future cash flows (cash inflows less cash outflows) that are directly associated with an intangible asset are used to determine the fair value of that asset. Management makes certain estimates and assumptions in determining the expected future cash flows from core deposit and customer relationship intangibles including account attrition, expected lives, discount rates, interest rates, servicing costs and other factors. Significant changes in these estimates and assumptions could adversely impact the valuation of these intangible assets. If an impairment loss exists, the carrying amount of the intangible asset is adjusted to a new cost basis. The new cost basis is then amortized over the remaining useful life of the asset. Based on its assessment, management concluded that there was no impairment of intangible assets at December 31, 2013 and December 31, 2012.

**(8) Deposits**

Time deposits of \$100,000 and over, including time deposits within the Certificate of Deposit Account Registry Service ("CDARS") and brokered deposits of \$100,000 and over, were \$256,198,000 and \$293,507,000 at December 31, 2013 and 2012, respectively. At December 31, 2013, total CDARS deposits of \$40,458,000 include money market deposits of \$34,789,000, which have no scheduled maturity date, and therefore, are excluded in the table below. The CDARS money market deposits at December 31, 2013, included \$27,463,000 in deposits from a law firm for legal settlements. All of the \$27,463,000 in deposits from the law firm were withdrawn in the first quarter of 2014. The following table presents the scheduled maturities of time deposits, including brokered deposits for the next five years:

|       | (Dollars in thousands) |         |
|-------|------------------------|---------|
| 2014  | \$                     | 238,795 |
| 2015  |                        | 18,179  |
| 2016  |                        | 20,783  |
| 2017  |                        | 83      |
| 2018  |                        | 4       |
| <br>  |                        |         |
| Total | \$                     | 277,844 |

At December 31, 2013, the Company had securities pledged with a fair value of \$107,965,000 for \$98,022,000 in certificates of deposits with the State of California. At December 31, 2012, the Company had securities pledged with a fair value of \$95,283,000 for \$85,033,000 in certificates of deposits with the State of California.

The CDARS program allows customers with deposits in excess of FDIC-insured limits to obtain full coverage on time deposits through a network of banks within the CDARS program. Deposits gathered through these programs are considered brokered deposits under current regulatory reporting guidelines. CDARS deposits were comprised of \$34,789,000 of money market accounts and \$5,669,000 of time

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deposits at December 31, 2013. CDARS deposits were comprised of \$5,022,000 of money market accounts and \$5,198,000 of time deposits at December 31, 2012.

Deposits from executive officers, directors, and their affiliates were \$3,122,000 and \$5,240,000 at December 31, 2013 and 2012, respectively.

**(9) Borrowing Arrangements***Federal Home Loan Bank Borrowings, Federal Reserve Bank Borrowings, and Available Lines of Credit*

The Company maintains a collateralized line of credit with the FHLB of San Francisco. Under this line, the Company can borrow from the FHLB on a short-term (typically overnight) or long-term (over one year) basis. As of December 31, 2013, and December 31, 2012, the Company had no overnight borrowings from the FHLB. The Company had \$253,472,000 of loans and no securities pledged to the FHLB as collateral on a line of credit of \$125,330,000 at December 31, 2013. The Company had \$192,771,000 of loans and no securities pledged to the FHLB as collateral on a line of credit of \$92,949,000 at December 31, 2012.

The Company can also borrow from the FRB's discount window. The Company had approximately \$323,209,000 of loans pledged to the FRB as collateral on an available line of credit of approximately \$241,515,000 at December 31, 2013, none of which was outstanding. The Company had approximately \$279,228,000 of loans pledged to the FRB as collateral on an available line of credit of approximately \$202,503,000 at December 31, 2012, none of which was outstanding.

At December 31, 2013, the Company has Federal funds purchase arrangements and lines of credit available of \$55,000,000. There were no Federal funds purchased at December 31, 2013 and 2012.

*Securities Sold Under Agreements to Repurchase*

Securities sold under agreements to repurchase are financing arrangements that mature within two and a half years. At maturity, the securities underlying the agreements are returned to the Company. Information concerning securities sold under agreements to repurchase is summarized as follows:

|   | December 31,           |       |          |
|---|------------------------|-------|----------|
|   | 2013                   | 2012  | 2011     |
|   | (Dollars in thousands) |       |          |
| Average balance during the year           | \$                     | \$    | \$ 712   |
| Average interest rate during the year     | 0.00%                  | 0.00% | 3.37%    |
| Maximum month-end balance during the year | \$                     | \$    | \$ 5,000 |
| Average rate at December 31,              | N/A                    | N/A   | N/A      |

*Subordinated Debt*

The Company has supported its growth through the issuance of trust preferred securities from special purpose trusts and accompanying sales of subordinated debt to these trusts. The subordinated debt issued to the trusts was senior to the outstanding shares of common stock and Series C Preferred Stock. As a result, payments were required on the subordinated debt before any dividends could be paid on the common stock and Series C Preferred Stock. Under the terms of the subordinated debt, the Company could defer interest payments for up to five years. Interest payments on the subordinated notes payable to the Company's subsidiary grantor Trusts were deductible for tax purposes. The subordinated debt was not

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

registered with the Securities and Exchange Commission. For regulatory reporting purposes, the subordinated debt qualified for Tier 1 capital treatment at December 31, 2012.

During the third quarter of 2012, the Company redeemed its 10.875% fixed-rate subordinated debentures in the amount of \$7,000,000 issued to Heritage Capital Trust I (and the related premium cost of \$304,500) and the Company's 10.600% fixed-rate subordinated debentures in the amount of \$7,000,000 issued to Heritage Statutory Trust I (and the related premium cost of \$296,800). The related trust securities issued by Capital Trust I and Statutory Trust I were also redeemed in connection with the subordinated debt redemption and the trusts were dissolved. A \$15,000,000 distribution from the Bank to the HCC provided the cash for the redemption. The Company incurred a charge of \$601,300 in 2012 for the early payoff premium on the redemption of the subordinated debt.

During the third quarter of 2013, the Company completed the redemption of its \$9,000,000 floating-rate subordinated debt. The Company redeemed its Floating Rate Junior Subordinated Debentures due July 31, 2031 in the amount of \$5,000,000 issued to Heritage Statutory Trust II and the Company's Floating Rate Junior Subordinated Debentures due September 26, 2032, in the amount of \$4,000,000 issued to Heritage Statutory Trust III. The related trust securities issued by Statutory Trust II and Statutory Trust III were also redeemed in connection with the subordinated debt redemption and the trusts were dissolved. The Company used available cash and proceeds from a \$9,000,000 distribution from the Bank for the redemption.

**(10) Income Taxes**

Income tax (benefit) consisted of the following for the year ended December 31, as follows:

|                                  | 2013                   | 2012     | 2011     |
|----------------------------------|------------------------|----------|----------|
|                                  | (Dollars in thousands) |          |          |
| Currently payable tax:           |                        |          |          |
| Federal                          | \$ 3,763               | \$ 2,944 | \$ 89    |
| State                            | 63                     | 51       | 140      |
| Total currently payable          | 3,826                  | 2,995    | 229      |
| Deferred tax (benefit):          |                        |          |          |
| Federal                          | (130)                  | 292      | 2,068    |
| State                            | 1,258                  | 1,007    | 569      |
| Deferred tax valuation allowance |                        |          | (3,700)  |
| Total deferred tax (benefit)     | 1,128                  | 1,299    | (1,063)  |
| Income tax (benefit)             | \$ 4,954               | \$ 4,294 | \$ (834) |

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The effective tax rate differs from the federal statutory rate for the years ended December 31, as follows:

|  | 2013         | 2012         | 2011         |
|--|--------------|--------------|--------------|
| Statutory Federal income tax rate                  | 35.0%        | 35.0%        | 35.0%        |
| State income taxes, net of federal tax benefit     | 5.3%         | 4.7%         | 4.4%         |
| Split dollar term insurance                        | 0.2%         | 0.0%         | 0.0%         |
| Change in valuation allowance                      | 0.0%         | 0.0%         | -35.1%       |
| Low income housing credits                         | -4.4%        | -6.0%        | -8.0%        |
| Increase in cash surrender value of life insurance | -3.5%        | -4.2%        | -5.7%        |
| Non-taxable interest income                        | -2.9%        | -0.3%        | 0.0%         |
| Other, net   | 0.3%         | 1.0%         | 1.5%         |
| <b>Effective tax rate</b>                          | <b>30.0%</b> | <b>30.2%</b> | <b>-7.9%</b> |

Deferred tax assets and liabilities that result from the tax effects of temporary differences between the carrying amount of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes at December 31, are as follows:

|   | 2013                   | 2012           |
|---|------------------------|----------------|
|   | (Dollars in thousands) |                |
| Deferred tax assets:                        |                        |                |
| Defined postretirement benefit obligation   | \$ 8,707               | \$ 8,956       |
| Allowance for loan losses                   | 8,058                  | 8,000          |
| Tax credit carryforwards                    | 3,958                  | 5,296          |
| Stock compensation                          | 1,697                  | 1,517          |
| California net operating loss carryforwards | 1,138                  | 2,281          |
| Accrued expenses                            | 1,029                  | 794            |
| Securities available-for-sale               | 668                    |                |
| Fixed assets                                | 613                    | 678            |
| Nonaccrual interest                         | 134                    | 99             |
| Split-dollar life insurance benefit plan    | 108                    | 103            |
| Other                                       | 451                    | 148            |
| <b>Total deferred tax assets</b>            | <b>26,561</b>          | <b>27,872</b>  |
| Deferred tax liabilities:                   |                        |                |
| Securities available-for-sale               |                        | (5,033)        |
| FHLB stock                                  | (263)                  | (263)          |
| Prepaid expenses                            | (481)                  | (359)          |
| Intangible assets                           | (642)                  | (841)          |
| I/O strips                                  | (691)                  | (1,036)        |
| Loan fees                                   | (1,025)                | (908)          |
| Other                                       | (133)                  | (168)          |
| <b>Total deferred tax liabilities</b>       | <b>(3,235)</b>         | <b>(8,608)</b> |

|                         |           |           |
|-------------------------|-----------|-----------|
| Net deferred tax assets | \$ 23,326 | \$ 19,264 |
|-------------------------|-----------|-----------|



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Tax credit carryforwards as of December 31, 2013 consist of the following:

|   | <b>2013</b>                   |                           |
|---|-------------------------------|---------------------------|
|   | <b>(Dollars in thousands)</b> |                           |
| Low income housing credits                    | \$ 3,041                      | (begin to expire in 2029) |
| Alternative Minimum Tax credits               | 870                           | (no expiration date)      |
| State tax credits, net of federal tax effects | 45                            | (no expiration date)      |
| New Hire Retention Credit                     | 2                             | (expires in 2031)         |
| <b>Total tax credit carryforwards</b>         | <b>\$ 3,958</b>               |                           |

If the Company were to generate a federal net operating loss, it would have the ability to carryback its net operating loss to recover some federal income taxes paid in prior years. Under current California law, if the Company were to generate a state net operating loss, it would have the ability to carryback 50% of the net operating loss to recover some state income taxes paid in prior years.

At year-end 2013, the Company has a California net operating loss carryforward of approximately \$16,148,000 that will begin to expire in 2031, if not utilized to reduce future taxable income.

Under generally accepted accounting principles, a valuation allowance is required if it is "more likely than not" that a deferred tax asset will not be realized. The determination of the realizability of the deferred tax assets is highly subjective and dependent upon judgment concerning management's evaluation of both positive and negative evidence, including forecasts of future income, cumulative losses, applicable tax planning strategies, and assessments of current and future economic and business conditions. The Company does not expect the total amount of unrecognized tax benefits to significantly increase or decrease in the next twelve months.

At December 31, 2013, and December 31, 2012, the Company had net deferred tax assets of \$23,326,000 and \$19,264,000, respectively. At December 31, 2013, the Company determined that a valuation allowance for deferred tax assets was not necessary.

The Company and its subsidiaries are subject to U.S. Federal income tax as well as income tax of the State of California. The Company is no longer subject to examination by federal and state taxing authorities for years before 2010 and 2009, respectively.

**(11) Equity Plan**

The Company maintained an Amended and Restated 2004 Equity Plan (the "2004 Plan") for directors, officers, and key employees. The 2004 Plan was terminated on May 23, 2013. On May 23, 2013, the Company's shareholders approved the 2013 Equity Incentive Plan (the "2013 Plan"). The equity plans provide for the grant of incentive and nonqualified stock options and restricted stock. The equity plans provide that the option price for both incentive and nonqualified stock options will be determined by the Board of Directors at no less than the fair value at the date of grant. Options granted vest on a schedule determined by the Board of Directors at the time of grant. Generally options vest over four years. All options expire no later than ten years from the date of grant. Restricted stock is subject to time vesting. As of December 31, 2013, the Company granted 294,550 shares of nonqualified stock options and 10,000 shares of restricted stock subject to time vesting requirements. There were no shares available under the 2004 Plan for new grants of stock options and restricted stock and 1,727,500 shares available for the issuance of equity awards under the 2013 Plan as of December 31, 2013.

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## HERITAGE COMMERCE CORP

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Stock option activity under the equity plans is as follows:

| Total Stock Options              | Number of Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Life (Years) | Aggregate Intrinsic Value |
|----------------------------------|------------------|---------------------------------|---|---------------------------|
| Outstanding at January 1, 2013   | 1,314,347        | \$ 12.90                        |   |                           |
| Granted                          | 294,550          | \$ 6.67                         |   |                           |
| Exercised                        | (18,791)         | \$ 4.67                         |   |                           |
| Forfeited or expired             | (83,602)         | \$ 12.53                        |   |                           |
| Outstanding at December 31, 2013 | 1,506,504        | \$ 11.80                        | 5.8   | \$ 2,040,000              |
| Vested or expected to vest       | 1,431,179        |                                 | 5.8   | \$ 1,938,000              |
| Exercisable at December 31, 2013 | 1,066,685        |                                 | 4.6   | \$ 1,195,000              |

Information related to the equity plans for each of the last three years:

|  | 2013      | 2012      | 2011    |
|--|-----------|-----------|---------|
| Intrinsic value of options exercised           | \$ 51,000 | \$ 10,000 | \$      |
| Cash received from option exercise             | \$ 88,000 | \$ 25,000 | \$      |
| Tax benefit realized from option exercises     | \$ 17,245 | \$ 3,000  | \$      |
| Weighted average fair value of options granted | \$ 3.84   | \$ 3.67   | \$ 2.89 |

As of December 31, 2013, there was \$1,649,000 of total unrecognized compensation cost related to nonvested stock options granted under the equity plans. That cost is expected to be recognized over a weighted-average period of approximately 3.0 years.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model that uses the assumptions noted in the following table, including the weighted average assumptions for the option grants in each year.

|   | 2013  | 2012  | 2011  |
|---|-------|-------|-------|
| Expected life in months(1)                  | 96    | 84    | 72    |
| Volatility(1)                               | 54%   | 57%   | 60%   |
| Weighted average risk-free interest rate(2) | 1.49% | 1.31% | 1.86% |
| Expected dividends(3)                       | 0.12% | 0.00% | 0.00% |

(1)

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The expected life of employee stock options represents the weighted average period the stock options are expected to remain outstanding based on historical experience. Volatility is based on the historical volatility of the stock price over the same period of the expected life of the option.

(2) Based on the U.S. Treasury constant maturity interest rate with a term consistent with the expected life of the option granted.

(3) Each grant's dividend yield is calculated by annualizing the most recent quarterly cash dividend and dividing that amount by the market price of the Company's common stock as of the grant date.

The Company estimates the impact of forfeitures based on historical experience. Should the Company's current estimate change, additional expense could be recognized or reversed in future periods. The Company issues authorized shares of common stock to satisfy stock option exercises.

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Restricted stock activity under the equity plans is as follows:

|                                       | Number<br>of Shares | Weighted<br>Average<br>Grant<br>Date<br>Fair<br>Value |
|---------------------------------------|---------------------|---|
| <b>Total Restricted Stock Award</b>   |                     |   |
| Nonvested shares at January 1, 2013   | 88,000              | \$ 5.74   |
| Granted                               | 10,000              | \$ 6.51   |
| Vested                                | (40,000)            | \$ 5.16   |
| <br>                                  |                     |   |
| Nonvested shares at December 31, 2013 | 58,000              | \$ 6.28   |

As of December 31, 2013, there was \$107,000 of total unrecognized compensation cost related to nonvested restricted stock awards granted under the 2004 Plan. The cost is expected to be recognized over a weighted-average period of approximately 7 months.

**(12) Benefit Plans*****401(k) Savings Plan***

The Company offers a 401(k) savings plan that allows employees to contribute up to a maximum percentage of their compensation, as established by the Internal Revenue Code. The Company made a discretionary matching contribution of up to \$1,000 for each employee's contributions in 2013, 2012 and 2011. Contribution expense was \$196,000, \$187,000, and \$183,000 in 2013, 2012 and 2011, respectively.

***Employee Stock Ownership Plan***

The Company sponsors a non-contributory employee stock ownership plan. To participate in this plan, an employee must have worked at least 1,000 hours during the year and must be employed by the Company at year-end. Employer contributions to the ESOP are discretionary. The Company has suspended contributions to the ESOP since 2010. At December 31, 2013, the ESOP owned 130,859 shares of the Company's common stock.

***Deferred Compensation Plan***

The Company has a nonqualified deferred compensation plan for its directors ("Deferral Agreements"). Under the Deferral Agreements, a participating director may defer up to 100% of his or her board fees into a deferred account. The director may elect a distribution schedule of up to ten years. Amounts deferred earn interest. The Company's deferred compensation obligation of \$113,000 and \$218,000 as of December 31, 2013 and 2012 is included in "Accrued interest payable and other liabilities."

The Company has purchased life insurance policies on the lives of two of its former directors who have Deferral Agreements. It is expected that the earnings on these policies will offset the cost of the program. In addition, the Company will receive death benefit payments upon the death of the former director. The proceeds will permit the Company to "complete" the deferral program as the former director originally intended if he dies prior to the completion of the deferral program. The disbursement of deferred fees is accelerated at death and commences one month after the former director dies.

In the event of the former director's disability prior to attainment of his benefit eligibility date, the former director may request that the Board permit him to receive an immediate disability benefit equal to the annualized value of the director's deferral account.



Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)*****Nonqualified Defined Benefit Pension Plan***

The Company has a supplemental retirement plan covering key executives and directors ("SERP"). The SERP is an unfunded, nonqualified defined benefit plan. The combined number of active and retired/terminated participants in the SERP was 53 at December 31, 2013. The defined benefit represents a stated amount for key executives and directors that generally vests over nine years and is reduced for early retirement. The projected benefit obligation is included in "Accrued interest payable and other liabilities" on the consolidated balance sheets. The SERP has no assets and the entire projected benefit obligation is unfunded. The measurement date of the SERP is December 31.

The following table sets forth the SERP's status at December 31:

|   | 2013                   | 2012      |
|---|------------------------|-----------|
|   | (Dollars in thousands) |           |
| Change in projected benefit obligation:           |                        |           |
| Projected benefit obligation at beginning of year | \$ 21,305              | \$ 19,200 |
| Service cost                                      | 1,214                  | 1,178     |
| Actuarial loss (gain)                             | (1,746)                | 915       |
| Interest cost                                     | 783                    | 770       |
| Benefits paid                                     | (844)                  | (758)     |
| <br>  |                        |           |
| Projected benefit obligation at end of year       | \$ 20,712              | \$ 21,305 |

Amounts recognized in accumulated other comprehensive loss:

|                    |          |          |
|--------------------|----------|----------|
| Net actuarial loss | \$ 3,813 | \$ 5,851 |
|--------------------|----------|----------|

Weighted-average assumptions used to determine the benefit obligation at year-end:

|                               | 2013  | 2012  |
|-------------------------------|-------|-------|
| Discount rate                 | 4.50% | 3.75% |
| Rate of compensation increase | N/A   | N/A   |

Estimated benefit payments over the next ten years, which reflect anticipated future events, service and other assumptions, are as follows:

| Year         | Estimated<br>Benefit<br>Payments |
|--------------|----------------------------------|
|              | (Dollars in thousands)           |
| 2014         | \$ 936                           |
| 2015         | 1,175                            |
| 2016         | 1,255                            |
| 2017         | 1,407                            |
| 2018         | 1,511                            |
| 2019 to 2023 | 8,408                            |

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The components of pension cost for the SERP follow:

|   | 2013                   | 2012     |
|---|------------------------|----------|
|   | (Dollars in thousands) |          |
| <b>Components of net periodic benefit cost:</b> |                        |          |
| Service cost                                    | \$ 1,214               | \$ 1,178 |
| Interest cost                                   | 783                    | 770      |
| Amortization of prior service cost              |                        | 27       |
| Amortization of net actuarial loss              | 291                    | 253      |
| <br>  |                        |          |
| Net periodic benefit cost                       | \$ 2,288               | \$ 2,228 |

The estimated net actuarial loss and prior service cost for the SERP that will be amortized from Accumulated Other Comprehensive Loss into net periodic benefit cost over the next fiscal year are \$142,000 and \$291,000 as of December 31, 2013 and 2012, respectively.

Net periodic benefit cost was determined using the following assumption:

|                               | 2013  | 2012  |
|-------------------------------|-------|-------|
| Discount rate                 | 3.75% | 4.10% |
| Rate of compensation increase | N/A   | N/A   |

***Split-Dollar Life Insurance Benefit Plan***

The Company maintains life insurance policies for current and former directors and officers that are subject to split-dollar life insurance agreements, which continues after the participant's employment and retirement. All participants are fully vested in their split-dollar life insurance benefits. The accrued benefit liability for the split-dollar insurance agreements represents either the present value of the future death benefits payable to the participants' beneficiaries or the present value of the estimated cost to maintain life insurance, depending on the contractual terms of the participant's underlying agreement.

The split-dollar life insurance projected benefit obligation is included in "Accrued interest payable and other liabilities" on the consolidated balance sheets. The measurement date of the split-dollar life insurance benefit plan is December 31.

During 2011, participants in the split-dollar life insurance benefit plan agreed to amend their agreements to provide a benefit for as long as the policies are in force, including a commitment to provide replacement coverage if the policies are ever surrendered.

The following sets forth the funded status of the split dollar life insurance benefits.

|   | 2013                   | 2012     |
|---|------------------------|----------|
|   | (Dollars in thousands) |          |
| <b>Change in projected benefit obligation:</b>    |                        |          |
| Projected benefit obligation at beginning of year | \$ 4,717               | \$ 4,525 |
| Interest cost                                     | 177                    | 185      |
| Actuarial loss                                    | (541)                  | 7        |

|   |          |          |
|---|----------|----------|
| Projected benefit obligation at end of year | \$ 4,353 | \$ 4,717 |
|---|----------|----------|



Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Amounts recognized in accumulated other comprehensive loss at December 31 consist of:

|                                      | 2013                   | 2012     |
|--------------------------------------|------------------------|----------|
|                                      | (Dollars in thousands) |          |
| Net actuarial loss                   | \$ 256                 | \$ 624   |
| Prior transition obligation          | 1,597                  | 1,685    |
| Accumulated other comprehensive loss | \$ 1,853               | \$ 2,309 |

Weighted-average assumption used to determine the benefit obligation at year-end follow:

|               | 2013  | 2012  |
|---------------|-------|-------|
| Discount rate | 4.50% | 3.75% |

Components of net periodic benefit cost during the year are:

|   | 2013                   | 2012    |
|---|------------------------|---------|
|   | (Dollars in thousands) |         |
| Amortization of prior transition obligation | \$ (84)                | \$ (73) |
| Interest cost                               | 177                    | 185     |
| Net periodic benefit cost                   | \$ 93                  | \$ 112  |

The estimated net actuarial loss and prior transition obligation for the split-dollar life insurance benefit plan that will be amortized from accumulated other comprehensive loss into net periodic benefit cost over the next fiscal year are \$90,000 as of December 31, 2013 and 2012.

Weighted-average assumption used to determine the net periodic benefit cost:

|               | 2013  | 2012  |
|---------------|-------|-------|
| Discount rate | 3.75% | 4.10% |

**(13) Fair Value**

Accounting guidance establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities in active markets; quoted prices for identical assets or liabilities in markets that are not active; or other inputs that are observable or can be corroborated by observable market data (for example, interest rates and yield curves observable at commonly quoted intervals, prepayment speeds, credit risks, and default rates).

Level 3: Significant unobservable inputs that reflect a reporting entity's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)*****Financial Assets and Liabilities Measured on a Recurring Basis***

The fair values of securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges (Level 1 inputs) or matrix pricing, which is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities, but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2 inputs).

The fair value of interest-only ("I/O") strip receivable assets is based on a valuation model used by a third party. The Company is able to compare the valuation model inputs and results to widely available published industry data for reasonableness (Level 2 inputs).

|                                   | Balance    | Fair Value Measurements Using   |   |
|-----------------------------------|------------|---|---|
|                                   |            | Quoted Prices in<br>Active Markets for<br>Identical Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) |
| (Dollars in thousands)            |            |   |   |
| Assets at December 31, 2013:      |            |   |   |
| Available-for-sale securities:    |            |   |   |
| Agency mortgage-backed securities | \$ 207,644 | \$  | \$ 207,644  |
| Corporate bonds                   | 52,046     |   | 52,046  |
| Trust preferred securities        | 20,410     |   | 20,410  |
| I/O strip receivables             | 1,647      |   | 1,647   |
| Assets at December 31, 2012:      |            |   |   |
| Available-for-sale securities:    |            |   |   |
| Agency mortgage-backed securities | \$ 291,244 | \$  | \$ 291,244  |
| Corporate bonds                   | 55,588     |   | 55,588  |
| Trust preferred securities        | 21,080     |   | 21,080  |
| I/O strip receivables             | 1,786      |   | 1,786   |

There were no transfers between Level 1 and Level 2 during the year for assets measured at fair value on a recurring basis.

***Assets and Liabilities Measured on a Non-Recurring Basis***

The fair value of impaired loans with specific allocations of the allowance for loan losses is generally based on recent real estate appraisals. The appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

Foreclosed assets are valued at the time the loan is foreclosed upon and the asset is transferred to foreclosed assets. The fair value is based primarily on third party appraisals, less costs to sell. The appraisals may utilize a single valuation approach or a combination of approaches including the comparable sales and income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are typically significant and result in a Level 3 classification of the inputs for determining fair value.

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## HERITAGE COMMERCE CORP

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## Assets and Liabilities Measured on a Non-Recurring Basis

|                                     | Balance  | Fair Value Measurements Using   |   |
|-------------------------------------|----------|---|---|
|                                     |          | Quoted Prices in<br>Active Markets for<br>Identical Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) |
| (Dollars in thousands)              |          |   |   |
| Assets at December 31, 2013:        |          |   |   |
| Impaired loans held-for-investment: |          |   |   |
| Commercial                          | \$ 1,780 |   | \$ 1,780  |
| Real estate:                        |          |   |   |
| Commercial and residential          | 2,846    |   | 2,846   |
| Land and construction               | 1,290    |   | 1,290   |
| Consumer                            | 100      |   | 100   |
|                                     | \$ 6,016 |   | \$ 6,016  |
| Foreclosed assets:                  |          |   |   |
| Land and construction               | \$ 575   |   | \$ 575  |
|                                     | \$ 575   |   | \$ 575  |
| Assets at December 31, 2012:        |          |   |   |
| Impaired loans held-for-investment: |          |   |   |
| Commercial                          | \$ 3,645 |   | \$ 3,645  |
| Real estate:                        |          |   |   |
| Commercial and residential          | 3,674    |   | 3,674   |
| Land and construction               | 1,723    |   | 1,723   |
| Consumer                            | 130      |   | 130   |
|                                     | \$ 9,172 |   | \$ 9,172  |
| Foreclosed assets:                  |          |   |   |
| Commercial and residential          | \$ 83    |   | \$ 83   |
| Land and construction               | 1,187    |   | 1,187   |

\$ 1,270

\$ 1,270

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following table shows the detail of the impaired loans held-for-investment and the impaired loans held-for-investment carried at fair value for the periods indicated:

|  | <b>December 31, 2013</b>      | <b>December 31, 2012</b> |
|--|-------------------------------|--------------------------|
|  | <b>(Dollars in thousands)</b> |                          |
| <b>Impaired loans held-for-investment:</b>                             |                               |                          |
| Book value of impaired loans held-for-investment carried at fair value | \$ 8,472                      | \$ 11,912                |
| Book value of impaired loans held-for-investment carried at cost       | 3,346                         | 7,732                    |
| <br>   |                               |                          |
| Total impaired loans held-for-investment                               | \$ 11,818                     | \$ 19,644                |
| <br>   |                               |                          |
| <b>Impaired loans held-for-investment carried at fair value:</b>       |                               |                          |
| Book value of impaired loans held-for-investment carried at fair value | \$ 8,472                      | \$ 11,912                |
| Specific valuation allowance   | (2,456)                       | (2,740)                  |
| <br>   |                               |                          |
| Impaired loans held-for-investment carried at fair value, net          | \$ 6,016                      | \$ 9,172                 |

Impaired loans held-for-investment of \$11,818,000 at December 31, 2013, after partial charge-offs of \$318,000 in 2013, were analyzed for additional impairment primarily using the fair value of collateral. In addition, these loans had a specific valuation allowance of \$2,456,000 at December 31, 2013. Impaired loans held-for-investment totaling \$8,472,000 at December 31, 2013 were carried at fair value as a result of the aforementioned partial charge-offs and specific valuation allowances at year-end. The remaining \$3,346,000 of impaired loans were carried at cost at December 31, 2013, as the fair value of the collateral exceeded the cost basis of each respective loan. Partial charge-offs and changes in specific valuation allowances during 2013 on impaired loans held-for-investment carried at fair value at December 31, 2013 resulted in an additional provision for loan losses of \$508,000.

At December 31, 2013, foreclosed assets had a carrying amount of \$575,000, with no valuation allowance at December 31, 2013.

Impaired loans held-for-investment of \$19,644,000 at December 31, 2012, after partial charge-offs of \$2,694,000 in 2012, were analyzed for additional impairment primarily using the fair value of collateral. In addition, these loans had a specific valuation allowance of \$2,740,000 at December 31, 2012. Impaired loans held-for-investment totaling \$11,912,000 at December 31, 2012 were carried at fair value as a result of the aforementioned partial charge-offs and specific valuation allowances at year-end. The remaining \$7,732,000 of impaired loans were carried at cost at December 31, 2012, as the fair value of the collateral exceeded the cost basis of each respective loan. Partial charge-offs and changes in specific valuation allowances during 2012 on impaired loans held-for-investment carried at fair value at December 31, 2012 resulted in an additional provision for loan losses of \$3,856,000.

At December 31, 2012, foreclosed assets had a carrying amount of \$1,270,000, with no valuation allowance at December 31, 2012.

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The following table presents quantitative information about level 3 fair value measurements for financial instruments measured at fair value on a non-recurring basis, except for consumer loans, at December 31, 2013 and 2012:

|  |    | <b>December 31, 2013</b> |                             |  |                                 |
|--|----|--------------------------|-----------------------------|--|---------------------------------|
|  |    | <b>Fair Value</b>        | <b>Valuation Techniques</b> | <b>Unobservable Inputs</b>                                   | <b>Range (Weighted Average)</b> |
| <b>(Dollars in thousands)</b>              |    |                          |                             |  |                                 |
| <b>Impaired loans held-for-investment:</b> |    |                          |                             |  |                                 |
| Commercial                                 | \$ | 1,780                    | Market Approach             | Discount adjustment for differences between comparable sales | 2% to 3% (2%)                   |
| <b>Real estate:</b>                        |    |                          |                             |  |                                 |
| Commercial and residential                 |    | 2,846                    | Market Approach             | Discount adjustment for differences between comparable sales | 1% to 15% (2%)                  |
| Land and construction                      |    | 1,290                    | Market Approach             | Discount adjustment for differences between comparable sales | 1% to 2% (2%)                   |
| <b>Foreclosed assets:</b>                  |    |                          |                             |  |                                 |
| Land and construction                      |    | 575                      | Market Approach             | Discount adjustment for differences between comparable sales | 1% to 16% (7%)                  |

|  |    | <b>December 31, 2012</b> |                             |  |                                 |
|--|----|--------------------------|-----------------------------|--|---------------------------------|
|  |    | <b>Fair Value</b>        | <b>Valuation Techniques</b> | <b>Unobservable Inputs</b>                                   | <b>Range (Weighted Average)</b> |
| <b>(Dollars in thousands)</b>              |    |                          |                             |  |                                 |
| <b>Impaired loans held-for-investment:</b> |    |                          |                             |  |                                 |
| Commercial                                 | \$ | 3,645                    | Market Approach             | Discount adjustment for differences between comparable sales | 0% to 4% (1%)                   |
| <b>Real estate:</b>                        |    |                          |                             |  |                                 |
| Commercial and residential                 |    | 3,674                    | Market Approach             | Discount adjustment for differences between comparable sales | 0% to 13% (1%)                  |
| Land and construction                      |    | 1,723                    | Market Approach             | Discount adjustment for differences between comparable sales | 1% to 4% (2%)                   |
| <b>Foreclosed assets:</b>                  |    |                          |                             |  |                                 |
| Land and construction                      |    | 1,187                    | Market Approach             | Discount adjustment for differences between comparable sales | 0% to 23% (6%)                  |

The Company obtains third party appraisals on its impaired loans held-for-investment and foreclosed assets to determine fair value. Generally, the third party appraisals apply the "market approach," which is a valuation technique that uses prices and other relevant information generated by market transactions involving identical or comparable (that is, similar) assets, liabilities, or a group of assets and liabilities, such as a business. Adjustments are then made based on the type of property, age of appraisal, current status of property and other related factors to estimate the current value of collateral.

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## HERITAGE COMMERCE CORP

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The carrying amounts and estimated fair values of the Company's financial instruments, at year-end were as follows:

|   | December 31, 2013 Estimated Fair Value |   |   |  |            |
|---|--|---|---|--|------------|
|   | Carrying<br>Amounts                    | Quoted Prices<br>in<br>Active Markets<br>for<br>Identical Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Total      |
| (Dollars in thousands)                              |  |   |   |  |            |
| <b>Assets:</b>                                      |  |   |   |  |            |
| Cash and cash equivalents                           | \$ 112,605                             | \$ 112,605  | \$  | \$   | \$ 112,605 |
| Securities available-for-sale                       | 280,100                                |   | 280,100   |  | 280,100    |
| Securities held-to-maturity                         | 95,921                                 |   | 86,032  |  | 86,032     |
| Loans (including loans<br>held-for-sale), net       | 898,897                                |   | 3,148   | 890,368  | 893,516    |
| FHLB and FRB stock                                  | 10,435                                 |   |   |  | N/A        |
| Accrued interest receivable                         | 4,085                                  |   | 1,729   | 2,356  | 4,085      |
| Loan servicing rights and I/O strips<br>receivables | 2,172                                  |   | 4,203   |  | 4,203      |
| <b>Liabilities:</b>                                 |  |   |   |  |            |
| Time deposits                                       | \$ 277,844                             | \$  | \$ 278,239  | \$   | \$ 278,239 |
| Other deposits                                      | 1,008,377                              |   | 1,008,377   |  | 1,008,377  |
| Accrued interest payable                            | 192                                    |   | 192   |  | 192        |

|   | December 31, 2012 Estimated Fair Value |   |   |  |            |
|---|--|---|---|--|------------|
|   | Carrying<br>Amounts                    | Quoted Prices<br>in<br>Active Markets<br>for<br>Identical Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Total      |
| (Dollars in thousands)                              |  |   |   |  |            |
| <b>Assets:</b>                                      |  |   |   |  |            |
| Cash and cash equivalents                           | \$ 373,565                             | \$ 373,565  | \$  | \$   | \$ 373,565 |
| Securities available-for-sale                       | 367,912                                |   | 367,912   |  | 367,912    |
| Securities held-to-maturity                         | 51,472                                 |   | 50,964  |  | 50,964     |
| Loans (including loans<br>held-for-sale), net       | 796,695                                |   | 3,409   | 793,911  | 797,320    |
| FHLB and FRB stock                                  | 10,728                                 |   |   |  | N/A        |
| Accrued interest receivable                         | 3,773                                  |   | 1,514   | 2,259  | 3,773      |
| Loan servicing rights and I/O strips<br>receivables | 2,495                                  |   | 4,715   |  | 4,715      |
| <b>Liabilities:</b>                                 |  |   |   |  |            |
| Time deposits                                       | \$ 318,664                             | \$  | \$ 319,476  | \$   | \$ 319,476 |
| Other deposits                                      | 1,160,704                              |   | 1,160,704   |  | 1,160,704  |
| Subordinated debt                                   | 9,279                                  |   |   | 5,400  | 5,400      |
| Accrued interest payable                            | 277                                    |   | 277   |  | 277        |



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**HERITAGE COMMERCE CORP**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The methods and assumptions, not previously discussed, used to estimate the fair value are described as follows:

***Cash and Cash Equivalents***

The carrying amounts of cash on hand, noninterest and interest bearing due from bank accounts, and Fed funds sold approximate fair values and are classified as Level 1.

***Loans***

The fair value of loans held-for-sale is estimated based upon binding contracts and quotes from third party investors resulting in a Level 2 classification.

Fair values of loans, excluding loans held for sale, are estimated as follows: For variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values resulting in a Level 3 classification. Fair values for other loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality resulting in a Level 3 classification. Impaired loans are valued at the lower of cost or fair value as described previously. The methods utilized to estimate the fair value of loans do not necessarily represent an exit price.

***FHLB and FRB Stock***

It was not practical to determine the fair value of FHLB and FRB stock due to the restrictions placed on transferability.

***Accrued Interest Receivable/Payable***

The carrying amounts of accrued interest approximate fair value resulting in a Level 2 or Level 3 classification.

***Deposits***

The fair values disclosed for demand deposits (e.g., interest and noninterest checking, passbook savings, and certain types of money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amount) resulting in a Level 2 classification. The carrying amounts of variable rate, fixed-term money market accounts approximate their fair values at the reporting date resulting in a Level 2 classification. The carrying amounts of variable rate, certificates of deposit approximate their fair values at the reporting date resulting in a Level 2 classification. Fair values for fixed rate certificates of deposit are estimated using a discounted cash flows calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits resulting in a Level 2 classification.

***Subordinated Debt***

The fair values of the subordinated debentures are estimated using discounted cash flow analyses based on the current borrowing rates for similar types of borrowing arrangements resulting in a Level 3 classification.

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)*****Off-Balance Sheet Items***

Fair values for off-balance sheet, credit-related financial instruments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing. The fair value of commitments is not material.

***Limitations***

Fair value estimates are made at a specific point in time, based on relevant market information about the financial instruments. These estimates do not reflect any premium or discount that could result from offering for sale at one time the entire holdings of a particular financial instrument. Fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

**(14) Commitments and Contingencies*****Financial Instruments with Off-Balance Sheet Risk***

HBC is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its clients. These financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized in the balance sheets.

HBC's exposure to credit loss in the event of non-performance of the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. HBC uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments. Credit risk is the possibility that a loss may occur because a party to a transaction failed to perform according to the terms of the contract. HBC controls the credit risk of these transactions through credit approvals, limits, and monitoring procedures. Management does not anticipate any significant losses as a result of these transactions.

Commitments to extend credit were as follows:

|  | December 31, 2013      |                  | December 31, 2012 |                  |
|--|------------------------|------------------|-------------------|------------------|
|  | Fixed<br>Rate          | Variable<br>Rate | Fixed<br>Rate     | Variable<br>Rate |
|  | (Dollars in thousands) |                  |                   |                  |
| Unused lines of credit and commitments to make loans | \$ 6,136               | \$ 359,955       | \$ 8,410          | \$ 291,191       |
| Standby letters of credit                            |                        | 11,099           | 2,200             | 7,051            |
|  | \$ 6,136               | \$ 371,054       | \$ 10,610         | \$ 298,242       |

Commitments generally expire within one year.

Standby letters of credit are written with conditional commitments issued by HBC to guarantee the performance of a client to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to clients.

The Company is required to maintain noninterest-bearing reserves. Reserve requirements are based on a percentage of certain deposits. As of December 31, 2013, the Company maintained reserves of



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**HERITAGE COMMERCE CORP**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

\$9,370,000 in the form of vault cash and balances at the Federal Reserve Bank of San Francisco, which satisfied the regulatory requirements.

***Loss Contingencies***

The Company's policy is to accrue for legal costs associated with both asserted and unasserted claims when it is probable that such costs will be incurred and such costs can be reasonably estimated. The Company has accrued for such costs associated with an asserted claim arising from an apparent transfer of funds for personal use by an authorized signatory of a customer. The litigation is in the very early stages and the Company intends to vigorously defend the litigation. At this time it is not possible to determine the amount of the loss, if any, arising from the claim in excess of the legal expenses expected to be incurred in defense of the litigation.

**(15) Shareholders' Equity and Earnings Per Share**

***Authorized Shares*** On May 27, 2010, the Company's shareholders approved an amendment to the Company's Articles of Incorporation to increase the number of authorized shares of common stock from 30,000,000 to 60,000,000. The additional authorized shares provide the Company greater flexibility for stock splits and stock dividends, issuances under employee benefit plans, financings, corporate mergers and acquisitions, and other general corporate purposes. As of December 31, 2013, the Company also had 10,000,000 authorized shares of preferred stock.

***Series A Preferred Stock*** On November 21, 2008, the Company issued 40,000 shares of Series A Fixed Rate Cumulative Perpetual Preferred Stock ("Series A Preferred Stock") to the U.S. Treasury under the terms of the U.S. Treasury Capital Purchase Program for \$40,000,000 with a liquidation preference of \$1,000 per share. On March 7, 2012, in accordance with approvals received from the U.S. Treasury and the Federal Reserve Board, the Company repurchased all of the Series A Preferred Stock and paid all of the related accrued and unpaid dividends. HCC used available cash and proceeds from a \$30,000,000 distribution approved by the California Department of Financial Institutions from HBC to HCC. The repurchase of the Series A Preferred Stock accelerated the accretion of the remaining issuance discount on the Series A Preferred Stock. Total dividends and discount accretion on Preferred Stock, including accelerated accretion of approximately \$765,000, reduced net income available to common shareholders by \$1,206,000 in the first quarter of 2012.

***Warrants*** On November 21, 2008, in conjunction with the issuance of the Series A Preferred Stock, the Company issued a warrant to the U.S Treasury with an initial exercise price of \$12.96 per share of common stock, with an allocated fair value of \$1,979,000. The warrant was exercisable at any time on or before November 21, 2018. The warrant was transferable at any time. On June 12, 2013, the Company completed the repurchase of the common stock warrant for \$140,000.

***Series C Preferred Stock*** On June 21, 2010, the Company issued to various institutional investors 21,004 shares of Series C Convertible Perpetual Preferred Stock ("Series C Preferred Stock"). The Series C Preferred Stock is mandatorily convertible into common stock at a conversion price of \$3.75 per share upon a subsequent transfer of the Series C Preferred Stock to third parties not affiliated with the holder in a widely dispersed offering. The 21,004 shares of Series C Preferred Stock remain outstanding as of December 31, 2013, and are convertible into 5,601,000 shares of common stock. The Series C Preferred Stock is non-voting except in the case of certain transactions that would affect the rights of the holders of the Series C Preferred Stock or applicable law. Holders of Series C Preferred Stock will receive dividends if and only to the extent dividends are paid to holders of common stock. The Series C Preferred Stock is

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not redeemable by the Company or by the holders and has a liquidation preference of \$1,000 per share. The Series C Preferred Stock ranks senior to the Company's common stock.

**Dividends** On January 23, 2014, the Company announced that its Board of Directors declared a \$0.04 per share quarterly cash dividend to holders of common stock and Series C preferred stock (on an as converted basis). The dividend was paid on February 25, 2014, to shareholders of record on February 5, 2014.

**Earnings Per Share** Basic earnings per common share is computed by dividing net income, less dividends and discount accretion on preferred stock, by the weighted average common shares outstanding. The Series C Preferred Stock participates in the earnings of the Company and, therefore, the shares issued on the conversion of the Series C Preferred Stock are considered outstanding under the two-class method of computing basic earnings per common share during periods of earnings. Diluted earnings per share reflect potential dilution from outstanding stock options and common stock warrants, using the treasury stock method. The common stock warrant was antidilutive at December 31, 2013, 2012, and 2011. The Company repurchased the warrant for \$140,000 in the second quarter of 2013. A reconciliation of these factors used in computing basic and diluted earnings per common share is as follows:

|   | Year ended December 31,                          |            |            |
|---|--|------------|------------|
|   | 2013   | 2012       | 2011       |
|   | (Dollars in thousands, except per share amounts) |            |            |
| Net income available to common shareholders                                       | \$ 11,204  | \$ 8,703   | \$ 9,038   |
| Less: undistributed earnings allocated to Series C Preferred Stock                | 1,687  | 1,527      | 1,589      |
| Distributed and undistributed earnings allocated to common shareholders           | \$ 9,517   | \$ 7,176   | \$ 7,449   |
| Weighted average common shares outstanding for basic earnings per common share    | 26,338,161                                       | 26,303,245 | 26,266,584 |
| Dilutive effect of stock options outstanding, using the the treasury stock method | 48,291   | 26,091     | 3,810      |
| Shares used in computing diluted earnings per common share                        | 26,386,452                                       | 26,329,336 | 26,270,394 |
| Basic earnings per share  | \$ 0.36  | \$ 0.27    | \$ 0.28    |
| Diluted earnings per share  | \$ 0.36  | \$ 0.27    | \$ 0.28    |

**(16) Capital Requirements**

The Company and its subsidiary bank are subject to various regulatory capital requirements administered by the banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's financial statements and operations. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and HBC must meet specific capital guidelines that involve quantitative measures of assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

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Quantitative measures established by regulation to help ensure capital adequacy require the Company and HBC to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital to average assets (as defined). Management believes that, as of December 31, 2013 and 2012, the Company and HBC met all capital adequacy guidelines to which they were subject.

As of December 31, 2013 HBC was categorized as "well-capitalized" under the regulatory framework for prompt corrective action. There are no conditions or events since December 31, 2013 that management believes have changed the categorization of the Company or HBC as well-capitalized.

The Company's consolidated capital amounts and ratios are presented in the following table, together with capital adequacy requirements.

|   | Actual     |       | To Be<br>Well-Capitalized<br>Under Regulatory<br>Requirements |       | Required For<br>Capital<br>Adequacy<br>Purposes |       |
|---|------------|-------|---|-------|---|-------|
|   | Amount     | Ratio | Amount  | Ratio | Amount  | Ratio |
| (Dollars in thousands)                      |            |       |   |       |   |       |
| As of December 31, 2013                     |            |       |   |       |   |       |
| Total Capital<br>(to risk-weighted assets)  | \$ 179,916 | 15.3% | \$ 117,581  | 10.0% | \$ 94,065                                       | 8.0%  |
| Tier 1 Capital<br>(to risk-weighted assets) | \$ 165,162 | 14.0% | \$ 70,549   | 6.0%  | \$ 47,032                                       | 4.0%  |
| Tier 1 Capital<br>(to average assets)       | \$ 165,162 | 11.2% | N/A   | N/A   | \$ 59,083                                       | 4.0%  |
| As of December 31, 2012                     |            |       |   |       |   |       |
| Total Capital<br>(to risk-weighted assets)  | \$ 171,201 | 16.2% | \$ 105,419  | 10.0% | \$ 84,335                                       | 8.0%  |
| Tier 1 Capital<br>(to risk-weighted assets) | \$ 157,947 | 15.0% | \$ 63,263   | 6.0%  | \$ 42,175                                       | 4.0%  |
| Tier 1 Capital<br>(to average assets)       | \$ 157,947 | 11.5% | N/A   | N/A   | \$ 55,130                                       | 4.0%  |

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HBC's actual capital and required amounts and ratios are presented in the following table.

|   | Actual     |       | To Be<br>Well-Capitalized<br>Under Prompt<br>Corrective Action<br>Provisions |       | Required For<br>Capital<br>Adequacy<br>Purposes |       |
|---|------------|-------|--|-------|---|-------|
|   | Amount     | Ratio | Amount   | Ratio | Amount  | Ratio |
| (Dollars in thousands)                      |            |       |  |       |   |       |
| <b>As of December 31, 2013</b>              |            |       |  |       |   |       |
| Total Capital<br>(to risk-weighted assets)  | \$ 163,827 | 13.9% | \$ 117,872   | 10.0% | \$ 94,297                                       | 8.0%  |
| Tier 1 Capital<br>(to risk-weighted assets) | \$ 149,037 | 12.6% | \$ 70,723  | 6.0%  | \$ 47,148                                       | 4.0%  |
| Tier 1 Capital<br>(to average assets)       | \$ 149,037 | 10.1% | \$ 73,858  | 5.0%  | \$ 59,086                                       | 4.0%  |
| <b>As of December 31, 2012</b>              |            |       |  |       |   |       |
| Total Capital<br>(to risk-weighted assets)  | \$ 161,004 | 15.3% | \$ 105,507   | 10.0% | \$ 84,406                                       | 8.0%  |
| Tier 1 Capital<br>(to risk-weighted assets) | \$ 147,742 | 14.0% | \$ 63,318  | 6.0%  | \$ 42,212                                       | 4.0%  |
| Tier 1 Capital<br>(to average assets)       | \$ 147,742 | 10.7% | \$ 68,910  | 5.0%  | \$ 55,128                                       | 4.0%  |

Due primarily to the redemption of \$9,000,000 of floating-rate subordinated debt in the third quarter of 2013, the Company's total risk-based capital ratio, Tier 1 risk-based capital ratio, and leverage ratio at December 31, 2013 decreased to 15.3%, 14.0%, and 11.2%, compared to 16.2%, 15.0%, and 11.5% at December 31, 2012, respectively. Due primarily to distributions from HBC to HCC totaling \$16,000,000 during 2013, HBC's total risk-based capital ratio, Tier 1 risk-based capital ratio, and leverage ratio at December 31, 2013 decreased to 13.9%, 12.6%, and 10.1%, compared to 15.3%, 14.0%, and 10.7% at December 31, 2012, respectively. However, at December 31, 2013, the Company's and HBC's capital ratios exceed the highest regulatory capital requirement of "well-capitalized" under prompt corrective action provisions.

HCC is dependent upon dividends from HBC. Under California General Corporation Law, the holders of common stock are entitled to receive dividends when and as declared by the Board of Directors, out of funds legally available. The California Financial Code provides that a state-licensed bank may not make a cash distribution to its shareholders in excess of the lesser of the following: (i) the bank's retained earnings; or (ii) the bank's net income for its last three fiscal years, less the amount of any distributions made by the bank to its shareholders during such period. However, a bank, with the prior approval of the Commissioner of the California Department of Financial Institutions may make a distribution to its shareholders of an amount not to exceed the greater of (i) a bank's retained earnings; (ii) its net income for its last fiscal year; or (iii) its net income for the current fiscal year. Also with the prior approval of the Commissioner of the California Department of Financial Institutions and the shareholders of the bank, the bank may make a distribution to its shareholders, as a reduction in capital of the bank. In the event that the Commissioner determines that the shareholders' equity of a bank is inadequate or that the making of a distribution by a bank would be unsafe or unsound, the Commissioner may order a bank to refrain from making such a proposed distribution. As of December 31, 2013, HBC would be required to obtain regulatory approval from the California Department of Financial Institutions for a dividend or other

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distribution to HCC. Similar restrictions applied to the amount and sum of loan advances and other transfers of funds from HBC to the parent company.

**(17) Parent Company only Condensed Financial Information**

The condensed financial statements of Heritage Commerce Corp (parent company only) are as follows:

**Condensed Balance Sheets**

|                                 | December 31,           |            |
|---------------------------------|------------------------|------------|
|                                 | 2013                   | 2012       |
|                                 | (Dollars in thousands) |            |
| <b>Assets</b>                   |                        |            |
| Cash and cash equivalents       | \$ 19,009              | \$ 11,193  |
| Investment in subsidiary bank   | 155,958                | 164,949    |
| Investment in subsidiary trusts |                        | 279        |
| Other assets                    |                        | 2,650      |
| <br>                            |                        |            |
| Total assets                    | \$ 174,967             | \$ 179,071 |

|   |            |            |
|---|------------|------------|
| <b>Liabilities and Shareholder's Equity</b> |            |            |
| Subordinated debt                           | \$         | \$ 9,279   |
| Other liabilities                           | 1,571      | 51         |
| Shareholder's equity                        | 173,396    | 169,741    |
| <br>  |            |            |
| Total liabilities and shareholder's equity  | \$ 174,967 | \$ 179,071 |

**Condensed Statements of Income**

|   | For the Year Ended December 31, |          |         |
|---|---------------------------------|----------|---------|
|   | 2013                            | 2012     | 2011    |
|   | (Dollars in thousands)          |          |         |
| Interest income   | \$                              | \$ 1     | \$ 10   |
| Dividend from subsidiary bank   | 16,000                          | 45,000   |         |
| Interest expense  | (229)                           | (1,383)  | (1,871) |
| Other expenses  | (2,080)                         | (2,615)  | (2,232) |
| <br>  |                                 |          |         |
| Income (loss) before income taxes and equity in net income of subsidiary bank | 13,691                          | 41,003   | (4,093) |
| Equity in net income of subsidiary bank:                                      |                                 |          |         |
| Reduction in contributed capital and distribution from subsidiary bank        | (16,000)                        | (45,000) |         |



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|   |           |          |          |
|---|-----------|----------|----------|
| Net income of subsidiary bank                       | 13,155    | 12,710   | 14,348   |
| Income tax benefit                                  | 694       | 1,196    | 1,116    |
| Net income  | 11,540    | 9,909    | 11,371   |
| Dividends and discount accretion on preferred stock | (336)     | (1,206)  | (2,333)  |
| Net income available to common shareholders         | \$ 11,204 | \$ 8,703 | \$ 9,038 |

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Condensed Statements of Cash Flows**

|  | <b>For the Year Ended December 31,</b> |             |             |
|--|--|-------------|-------------|
|  | <b>2013</b>                            | <b>2012</b> | <b>2011</b> |
|  | <b>(Dollars in thousands)</b>          |             |             |
| <b>Cash flows from operating activities:</b>   |  |             |             |
| Net Income   | \$ 11,540                              | \$ 9,909    | \$ 11,371   |
| <b>Adjustments to reconcile net income to net cash provided by (used in) operations:</b> |  |             |             |
| Amortization of restricted stock award, net of forfeitures and taxes                     | 200                                    | 148         | 75          |
| Equity in undistributed loss/(net income) of subsidiary bank                             | 2,845                                  | 32,290      | (14,348)    |
| Net change in other assets and liabilities   | 4,478                                  | (744)       | (1,182)     |
| <br>   |  |             |             |
| Net cash provided by (used in) operating activities                                      | 19,063                                 | 41,603      | (4,084)     |
| <b>Cash flows from financing activities:</b>   |  |             |             |
| Repayment of subordinated debt   | (9,279)                                | (14,423)    |             |
| Payment of cash dividends  | (1,916)                                | (373)       | (4,672)     |
| Repayment of preferred stock   |  | (40,000)    |             |
| Issuance of common stock, net of issuance costs  | 88                                     | 39          |             |
| Payment of repurchase of common stock warrant  | (140)                                  |             |             |
| <br>   |  |             |             |
| Net cash used in financing activities  | (11,247)                               | (54,757)    | (4,672)     |
| <br>   |  |             |             |
| Net increase (decrease) in cash and cash equivalents                                     | 7,816                                  | (13,154)    | (8,756)     |
| Cash and cash equivalents, beginning of year   | 11,193                                 | 24,347      | 33,103      |
| <br>   |  |             |             |
| Cash and cash equivalents, end of year   | \$ 19,009                              | \$ 11,193   | \$ 24,347   |

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(18) Quarterly Financial Data (Unaudited)**

The following table discloses the Company's selected unaudited quarterly financial data:

|   | <b>For the Quarter Ended</b>                            |                 |                 |                 |
|---|---|-----------------|-----------------|-----------------|
|   | <b>12/31/13</b>   | <b>09/30/13</b> | <b>06/30/13</b> | <b>03/31/13</b> |
|   | <b>(Dollars in thousands, except per share amounts)</b> |                 |                 |                 |
| Interest income                                     | \$ 13,623   | \$ 13,458       | \$ 12,838       | \$ 12,867       |
| Interest expense                                    | 574   | 627             | 685             | 714             |
| <br>  |   |                 |                 |                 |
| Net interest income                                 | 13,049  | 12,831          | 12,153          | 12,153          |
| Provision (credit) for loan losses                  | (12)  | (534)           | (270)           |                 |
| <br>  |   |                 |                 |                 |
| Net interest income after provision for loan losses | 13,061  | 13,365          | 12,423          | 12,153          |
| Noninterest income                                  | 1,898   | 1,738           | 1,915           | 1,663           |
| Noninterest expense                                 | 10,172  | 10,380          | 10,389          | 10,781          |
| <br>  |   |                 |                 |                 |
| Income before income taxes                          | 4,787   | 4,723           | 3,949           | 3,035           |
| Income tax expense                                  | 1,433   | 1,510           | 1,156           | 855             |
| <br>  |   |                 |                 |                 |
| Net income  | 3,354   | 3,213           | 2,793           | 2,180           |
| Dividends on preferred stock                        | (168)   | (168)           |                 |                 |
| <br>  |   |                 |                 |                 |
| Net income available to common shareholders         | \$ 3,186  | \$ 3,045        | \$ 2,793        | \$ 2,180        |
| <br>  |   |                 |                 |                 |
| <b>Earnings per common share</b>                    |   |                 |                 |                 |
| Basic   | \$ 0.10   | \$ 0.10         | \$ 0.09         | \$ 0.07         |
| Diluted   | \$ 0.10   | \$ 0.10         | \$ 0.09         | \$ 0.07         |

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|  | For the Quarter Ended                            |           |           |           |
|--|--|-----------|-----------|-----------|
|  | 12/31/12   | 09/30/12  | 06/30/12  | 03/31/12  |
|  | (Dollars in thousands, except per share amounts) |           |           |           |
| Interest income  | \$ 12,958  | \$ 12,862 | \$ 13,296 | \$ 13,449 |
| Interest expense                                       | 747  | 1,038     | 1,212     | 1,190     |
| Net interest income                                    | 12,211   | 11,824    | 12,084    | 12,259    |
| Provision for loan losses                              | 669  | 1,200     | 815       | 100       |
| Net interest income after provision for loan losses    | 11,542   | 10,624    | 11,269    | 12,159    |
| Noninterest income                                     | 2,104  | 2,948     | 2,090     | 1,723     |
| Noninterest expense                                    | 9,799  | 10,147    | 9,454     | 10,856    |
| Income before income taxes                             | 3,847  | 3,425     | 3,905     | 3,026     |
| Income tax expense                                     | 1,178  | 939       | 1,226     | 951       |
| Net income   | 2,669  | 2,486     | 2,679     | 2,075     |
| Dividends and discount accretion on preferred stock(1) |  |           |           | (1,206)   |
| Net income available to common shareholders            | \$ 2,669   | \$ 2,486  | \$ 2,679  | \$ 869    |
| <b>Earnings per common share</b>                       |  |           |           |           |
| Basic  | \$ 0.08  | \$ 0.08   | \$ 0.08   | \$ 0.03   |
| Diluted  | \$ 0.08  | \$ 0.08   | \$ 0.08   | \$ 0.03   |

(1)

The Company repurchased the \$40,000,000 of Series A preferred stock issued to the U.S. Treasury Department under the TARP Capital Purchase Program during the first quarter of 2012. The Series A Preferred Stock was initially recorded at a discount, and the repurchase accelerated the accretion of the remaining discount on the Series A Preferred Stock. While the accelerated accretion did not impact net income, it resulted in a one-time non-cash reduction in net income available to common shareholders of approximately \$765,000 in the first quarter of 2012. Total dividends and discount accretion on the Series A Preferred Stock, including the accelerated accretion, reduced net income available to common shareholders by \$1,206,000 in the first quarter of 2012.

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#### EXHIBIT INDEX

| <b>Exhibit Number</b> | <b>Description</b>  |
|-----------------------|---|
| 2.1                   | Agreement and Plan of Merger, dated February 8, 2007, by and between Heritage Commerce Corp, Heritage Bank of Commerce and Diablo Valley Bank (incorporated by reference from the Registrant's Annual Report on Form 10-K filed on March 16, 2007)          |
| 3.1                   | Restated Articles of Incorporation of Heritage Commerce Corp (incorporated by reference from the Registrant's Annual Report on Form 10-K filed on March 16, 2009)   |
| 3.2                   | Certificate of Amendment of Articles of Incorporation of Heritage Commerce Corp, as filed with the California Secretary of State on June 1, 2010 (incorporated by reference from the Registration Statement on Form S-1 filed July 23, 2010)                |
| 3.3                   | Bylaws, as amended, of Heritage Commerce Corp (incorporated by reference from the Registration Statement on Form S-1 filed July 23, 2010)   |
| 4.1                   | Certificate of Determination of Series C Convertible Perpetual Preferred Stock, as filed with the California Secretary of State on June 17, 2010 (incorporated herein by reference from the Registrant's Current Report on Form 8-K as filed June 22, 2010) |
| 10.1                  | Real Property Leases for Registrant's Principle Office (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed March 5, 1998)  |
| 10.2                  | Third Amendment to Lease for Registrant's Principle Office (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed August 17, 2005)  |
| 10.3                  | Fourth Amendment to Lease for Registrant's Principle Office (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed August 17, 2005)   |
| 10.4                  | Fourth Amendment to Sublease for Registrant's Principle Office (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed June 22, 2005)  |
| *10.5                 | Heritage Commerce Corp Management Incentive Plan (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed May 3, 2005)  |
| *10.6                 | 1994 Stock Option Plan and Form of Agreement (incorporated herein by reference from the Registrant's Registration Statement on Form S-8 filed July 17, 1998)  |
| *10.7                 | Amended and Restated 2004 Equity Plan (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed June 2, 2009)  |
| *10.8                 | Restricted Stock Agreement with Walter Kaczmarek dated March 17, 2005 (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed March 22, 2005)  |
| *10.9                 | 2004 Stock Option Agreement with Walter Kaczmarek dated March 17, 2005 (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed March 22, 2005)   |
| *10.10                | Non-qualified Deferred Compensation Plan (incorporated herein by reference from the Registrant's Annual Report on Form 10-K filed March 31, 2005)   |
| *10.11                | Amended and Restated Employment Agreement with Walter Kaczmarek, dated October 17, 2007 (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed October 22, 2007)  |
| *10.12                | Amended and Restated Employment Agreement with Lawrence McGovern, dated July 21, 2011 (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed July 21, 2011)   |



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| <b>Exhibit Number</b> | <b>Description</b>  |
|-----------------------|---|
| *10.13                | Employment Agreement with Dan T. Kawamoto, dated June 11, 2009 (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed June 16, 2009)  |
| *10.14                | Employment Agreement with Michael E. Benito, dated February 1, 2012 (incorporated by reference from the Registrant's Current Report on Form 8-K filed February 1, 2012)   |
| *10.15                | Employment Agreement with David Porter, dated June 25, 2012 (incorporated by reference from the Registrant's Current Report on Form 8-K filed June 25, 2012)  |
| *10.16                | Employment Agreement with Keith Wilton, dated February 18, 2014 (incorporated by reference from the Registrant's Current Report on Form 8-K filed February 20, 2014)  |
| *10.17                | Form of Stock Option Agreement For Amended and Restated 2004 Equity Plan (incorporated by reference from the Registrant's Annual Report on Form 10-K filed March 9, 2012)   |
| *10.18                | Form of Restricted Stock Agreement For Amended and Restated 2004 Equity Plan (incorporated by reference from the Registrant's Annual Report on Form 10-K filed March 9, 2012)   |
| *10.19                | 2013 Equity Incentive Plan (incorporated by reference from the Registrant's Registration Statement in Form S-8 filed July 15, 2013)   |
| *10.20                | Form of Restricted Stock Agreement For 2013 Equity Incentive Plan (incorporated by reference from the Registrant's Registration Statement on Form S-8 filed July 15, 2013)  |
| *10.21                | Form of Stock Option Agreement for 2013 Equity Incentive Plan (incorporated by reference from the Registrant's Registration Statement on Form S-8 filed July 15, 2013)  |
| *10.22                | 2005 Amended and Restated Heritage Commerce Corp Supplemental Retirement Plan (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed September 30, 2008)  |
| *10.23                | Form of Endorsement Method Split Dollar Plan Agreement for Executive Officers (incorporated herein by reference from the Registrant's Annual Report on Form 10-K filed March 17, 2008)  |
| *10.24                | Form of Endorsement Method Split Dollar Plan Agreement for Directors (incorporated herein by reference from the Registrant's Annual Report on Form 10-K filed March 17, 2008)   |
| *10.25                | Amendment No. 1 to Employment Agreement, dated December 29, 2008 between the Company and Walter T. Kaczmarek (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed January 2, 2009)                        |
| *10.26                | First Amended and Restated Director Compensation Benefits Agreement dated December 29, 2008 between Jack Conner and the Company (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed January 2, 2009)     |
| *10.27                | First Amended and Restated Director Compensation Benefits Agreement dated December 29, 2008 between Frank Bisceglia and the Company (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed January 2, 2009) |
| *10.28                | First Amended and Restated Director Compensation Benefits Agreement dated December 29, 2008 between Robert Moles and the Company (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed January 2, 2009)    |

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| <b>Exhibit<br/>Number</b> | <b>Description</b>  |
|---------------------------|---|
| *10.29                    | First Amended and Restated Director Compensation Benefits Agreement dated December 29, 2008 between Humphrey Polanen and the Company (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed January 2, 2009)      |
| *10.30                    | First Amended and Restated Director Compensation Benefits Agreement dated December 29, 2008 between Charles Toeniskoetter and the Company (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed January 2, 2009) |
| *10.31                    | First Amended and Restated Director Compensation Benefits Agreement dated December 29, 2008 between Ranson Webster and the Company (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed January 2, 2009)        |
| 10.32                     | Form of Indemnification Agreement between the Registrant and its directors and executive officers (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed December 23, 2009)                                       |
| 10.33                     | Securities Purchase Agreement between the Company and each of the Purchasers, dated as of June 18, 2010 (incorporated herein from the Registrant's Current Report on Form 8-K as filed June 22, 2010)   |
| 10.34                     | Registration Rights Agreement between the Company and each of the Purchasers, dated as of June 18, 2010 (incorporated herein from the Registrant's Current Report on Form 8-K as filed June 22, 2010)   |
| 12.1                      | Calculation of consolidated ratio of earnings to fixed charges and consolidated ratio of earnings to fixed charges and preferred stock dividends  |
| 21.1                      | Subsidiaries of Registrant (incorporated by reference from the Registrant's Annual Report on Form 10-K filed March 16, 2007)  |
| 23.1                      | Consent of Crowe Horwath LLP  |
| 31.1                      | Certification of Registrant's Chief Executive Officer Pursuant to Section 302 of the Sarbanes Oxley Act of 2002   |
| 31.2                      | Certification of Registrant's Chief Financial Officer Pursuant to Section 302 of the Sarbanes Oxley Act of 2002   |
| 32.1                      | Certification of Registrant's Chief Executive Officer Pursuant to 18 U.S.C. Section 1350  |
| 32.2                      | Certification of Registrant's Chief Financial Officer Pursuant to 18 U.S.C. Section 1350  |
| 101.INS                   | XBRL Instance Document, furnished herewith  |
| 101.SCH                   | XBRL Taxonomy Extension Schema Document, furnished herewith   |
| 101.CAL                   | XBRL Taxonomy Extension Calculation Linkbase Document, furnished herewith   |
| 101.DEF                   | XBRL Taxonomy Extension Definition Linkbase Document, furnished herewith  |
| 101.LAB                   | XBRL Taxonomy Extension Label Linkbase Document, furnished herewith   |
| 101.PRE                   | XBRL Taxonomy Extension Presentation Linkbase Document, furnished herewith  |

\*

Management contract or compensatory plan or arrangement.