HERITAGE COMMERCE CORP
Form 10-K
March 09, 2012

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(MARK ONE)

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

For the fiscal year ended December 31, 2011

OR

o **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	**77-0469558**
(State or Other Jurisdiction of Incorporation or Organization)	*(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:

Title of Each Class	Name of Each Exchange on which Registered
Common Stock, no par value	The NASDAQ Stock Market LLC (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 o No ý

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or I5(d) of the Act. Yes o No ý

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 ý No o

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

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. ý

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 filer o	Accelerated filerý	Non-accelerated filer o	Smaller reporting company o
		(Do not check if a smaller reporting company)	

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

The aggregate market value of the common stock held by non-affiliates of the Registrant as of June 30, 2011, based upon the closing price on that date of $5.11 per share, and 18,590,812 shares held, as reported on the NASDAQ Global Select Market, was approximately $95.0 million.

As of February 15, 2012, there were 26,286,501 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 2012 Annual Meeting of Shareholders to be held on May 24, 2012 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, 2011.

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FOR YEAR ENDED DECEMBER 31, 2011

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:

- Competition for loans and deposits and failure to attract or retain deposits and loans;
- 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;
- Risks associated with concentrations in real estate related loans;
- 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;
- 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;
- Stability of funding sources and continued availability of borrowings;
- 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;
- Continued volatility in credit and equity markets and its effect on the global economy;
- The impact of reputational risk on such matters as business generation and retention, funding and liquidity;
- Oversupply of inventory and continued deterioration in values of California commercial real estate;

A prolonged slowdown in construction activity;

The effect of changes in laws and regulations (including laws and regulations concerning taxes, banking, securities, and executive compensation) which we must comply, including but not limited to, the Dodd-Frank Act of 2010;

The effects of security breaches and computer viruses that may affect our computer systems;

Changes in consumer spending, borrowings and saving habits;

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- 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;
- The ability to increase market share and control expenses; 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.

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 SBA guaranteed loans. We generally lend in markets where we have a physical presence through our branch offices and a 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 California Department 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.

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At December 31, 2011, we had consolidated assets of $1.31 billion, deposits of $1.05 billion and shareholders' equity of $197.8 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 Main Branch 150 Almaden Boulevard San Jose, CA 95113
Fremont:	Branch Office 3077 Stevenson Boulevard Fremont, CA 94538
Danville:	Branch Office 387 Diablo Road Danville, CA 94526
Gilroy:	Branch Office 7598 Monterey Street Suite 110 Gilroy, CA 95020
Los Altos:	Branch Office 419 South San Antonio Road Los Altos, CA 95032
Los Gatos:	Branch Office 15575 Los Gatos Boulevard Los Gatos, CA 95032
Morgan Hill:	Branch Office 18625 Sutter Boulevard Morgan Hill, CA 95037

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Mountain View:	Branch Office 175 E. El Camino Real Mountain View, CA 94040
Pleasanton:	Branch Office 300 Main Street Pleasanton, CA 94566
Walnut Creek:	Branch Office 101 Ygnacio Valley Road Suite 100 Walnut Creek, CA 94596

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 Small Business Administration ("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. The terms of commercial construction loans are made in accordance with our commercial loan policy. Advances on construction loans are made in accordance

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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-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, 2011, 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 48% (including SBA loans); (ii) real estate secured loans 41%; (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.

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.

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. At December 31, 2011, HBC had approximately 14,900 deposit accounts totaling $1.05 billion, including brokered deposits, compared to 15,600 deposit accounts totaling approximately $993.9 million as of December 31, 2010.

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 six 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. The Series A Preferred Stock carried a coupon of 5% for five years and 9% thereafter. The Series A Preferred Stock was non-voting, cumulative, and perpetual and could be redeemed at 100% of its liquidation preference plus accrued and unpaid dividends. In addition, HCC issued a warrant to the U.S. Treasury to purchase 462,963 shares of HCC's common stock. The warrant is exercisable immediately at a price of $12.96 per share, will expire after a period of 10 years from issuance and is transferable by the U.S. Treasury. The U.S. Treasury may transfer a portion or portions of the warrant, and/or exercise the warrant at any time. The U.S. Treasury has agreed not to exercise voting power with respect to any common shares issued to it upon exercise of the warrant. At December 31, 2011, there had been no changes to the number of common shares covered by the warrant nor had the U.S. Treasury exercised any portion of the warrant.

Under the terms of the Capital Purchase Program, HCC was prohibited from increasing dividends above $0.08 per share on its common stock, and from making certain repurchases of equity securities,

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including its common stock, without the U.S. Treasury's consent. Furthermore, as long as the Series A Preferred Stock was outstanding, dividend payments and repurchases or redemptions relating to certain equity securities, including HCC's common stock, were prohibited until all accrued and unpaid dividends were paid on the Series A Preferred Stock.

As permitted under the terms of the Series A Preferred Stock, in November 2009, the Company announced that it was exercising its right to suspend payment of dividends on its Series A Preferred Stock. As a result, the Company had accrued but had not paid approximately $2.8 million in dividends on its Series A Preferred Stock as of December 31, 2010. In 2011, the Board of Directors declared a dividend on the Series A Preferred Stock in an aggregate amount of $4.7 million. A $4.2 million dividend was paid on August 1, 2011. Of the August 2011 aggregate dividend declared and paid, $3.5 million was attributable to the dividend periods ending November 15, 2009 through May 15, 2011, $172,000 was for interest on the deferred dividend payments, and $500,000 was the dividend payable for the period ended August 15, 2011. On November 15, 2011, the Company paid the regularly scheduled dividend of $500,000, per the terms of the Series A Preferred 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. At the time the Company repurchased the Series A Preferred Stock, it did not repurchase the related warrant. The warrant was outstanding as of the date of this report. 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.

Regulatory Action

On February 17, 2010 HCC and HBC entered into a Written Agreement with the Federal Reserve Bank of San Francisco, and the DFI. Under the terms of the Written Agreement, the Company had to obtain the prior written approval of the Federal Reserve and DFI before it could: (i) declare or pay any dividends on common stock or preferred stock; (ii) make any distributions of principal or interest on HCC's outstanding trust preferred securities and related subordinated debt; (iii) incur, increase or guarantee any debt; (iv) redeem any outstanding stock, or; (v) take dividends or any other form of payment that represented a reduction in capital from HBC. The Written Agreement required the Company to submit written plans within certain timeframes to the Federal Reserve and the DFI that addressed the following items: (i) strengthening credit risk management practices; (ii) improving HBC's position with respect to problem loans in excess of $2 million; (iii) maintaining adequate reserves for loan and lease losses; (iv) maintaining sufficient capital at HCC and HBC; (v) improving the management of HBC's liquidity position and funds management practices; and (vi) improving the Company's earnings and overall condition through a business plan and budget. All plans were submitted to the appropriate regulatory agencies, and all plans requiring approval by such agencies were approved.

In addition, the Agreement: (i) required HBC's Board of Directors or a designated committee thereof to approve any extension, renewal or restructuring of any credit to any borrower whose loans have been "criticized"; (ii) required HBC to charge off loans classified as "loss" by the Federal Reserve and/or DFI; (iii) required the Company to notify the Federal Reserve and DFI no more than 30 days after the end of any quarter in which the capital ratios of HCC or HBC fell below the approved capital plan' minimum levels; (iv) required HCC and HBC to comply with the notice provisions of Section 32 of the Federal Deposit Insurance Act and Subpart H of Regulation Y of the Board of Governors of the Federal Reserve System in connection with appointing any new director or senior executive officer or changing the responsibilities of any senior executive officer so that the officer would assume a different senior executive officer position; (v) required HCC and HBC to comply with the restrictions on indemnification and severance payments of Section 18(k) of the Federal Deposit Insurance Act and Part 359 of the FDIC's regulations; and (vi) required the Company to provide quarterly progress reports to the Federal Reserve and the DFI.

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In June 2011, the Federal Reserve and the DFI issued a joint order terminating the regulatory Written Agreement. Effective June 9, 2011, the Company and HBC were no longer subject to the terms and conditions of the Written Agreement.

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 mandatorily convertible into common stock upon approval by the shareholders 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 both approval by the shareholders and, thereafter, a subsequent transfer of the Series C Preferred Stock to third parties not affiliated with the holder in a widely dispersed offering. At HCC's Special Meeting of Shareholders held on September 15, 2010, HCC's shareholders approved the issuance of common stock upon the conversion of the Series B Preferred Stock and upon the conversion of the Series C Preferred Stock as required by The NASDAQ Stock Market and California corporate law. As a result, on September 16, 2010, the Series B Preferred Stock was converted into 14,398,992 shares of common stock of HCC and the shares of Series B Preferred Stock ceased to be outstanding. The Series C Preferred Stock remains outstanding until it has been converted into common stock in accordance with its terms. 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 and ranks on parity with HCC's Series A Preferred 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 275 offices that control a combined 56.53% of deposit market share based on June 30, 2011 FDIC market share data. HBC ranks fifteenth with 0.81% share of total deposits based on June 30, 2011 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. 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, mortgage companies, credit unions, finance 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. Competitors offering such products include traditional banks and savings associations, credit unions, brokerage firms, asset management groups, finance and insurance companies, internet-based companies, and mortgage banking firms.

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 and HBC 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

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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.

The Dodd-Frank Wall Street Reform and Consumer Protection Act

The Dodd-Frank Act of 2010, as amended ("Dodd-Frank"), represents landmark legislation which followed other legislative and regulatory initiatives in 2008 and 2009 in response to the economic downturn and financial industry instability. 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 interagency cooperation;

- expanded FDIC resolution 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;

- 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 and an extension of federal deposit coverage until January 1, 2013, for the full net amount held by depositors in non-interesting bearing transaction accounts;

- 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, will be its average consolidated total assets less its average tangible equity and increase the minimum reserve ratio for the Deposit Insurance Fund from 1.15% to 1.35%;

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;

- provisions that affect corporate governance and executive compensation at most United States publicly traded companies, including: (i) stockholder advisory votes on executive compensation; (ii) executive compensation "clawback" requirements for companies listed on national securities exchanges in the event of materially inaccurate statements of earnings, revenues, gains or other criteria; (iii) enhanced independence requirements for compensation committee members; and (iv) authority for the SEC to adopt proxy access rules which would permit stockholders of publicly traded companies to nominate candidates for election as director and have those nominees included in a company's proxy statement; and

- 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.

We cannot predict the extent to which the interpretations and implementation of this wide-ranging federal legislation may affect us. Many of the requirements of Dodd-Frank will be implemented over time and most will be subject to regulations implemented over the course of several years. There can be no assurance that these or future reforms (such as possible new standards for commercial real estate lending or new stress testing guidance for all banks) arising out of studies and reports required by Dodd-Frank will not significantly increase our compliance or other operating costs or otherwise have a significant impact on our business, financial condition and results of operations. Dodd-Frank is likely to impose upon us more stringent capital, liquidity and leverage requirements or otherwise adversely affect our business. As a result of the changes required by Dodd-Frank, the profitability of our business activities may be impacted and we may be required to make changes to certain of our business practices. These changes may also require us to invest significant management attention and resources to evaluate and make any changes necessary to comply with new statutory and regulatory requirements.

EESA and ARRA

Previous legislation enacted in response to the recent economic downturn and financial industry instability included the Emergency Economic Stabilization Act of 2008 ("EESA"), enacted on October 3, 2008, and the American Recovery and Reinvestment Act of 2009 ("ARRA"), enacted on February 17, 2009.

Pursuant to EESA, the United States Department of the Treasury ("U.S. Treasury") was authorized to create the $700 billion Troubled Assets Relief Program ("TARP") to purchase, insure, hold and sell a wide variety of financial instruments, and, as implemented under the Capital Purchase Program, included authorization for up to $250 billion in senior preferred stock of qualifying United States banks and savings associations or their holding companies.

On November 21, 2008, the Company entered into a Securities Purchase Agreement Standard Terms with the U.S. Treasury, pursuant to which, among other things, the Company sold Series A Preferred Stock and a warrant to purchase 462,963 shares of common stock to the U.S. Treasury for an aggregate purchase price of $40 million. Under the terms of the Capital Purchase Program, the Company was prohibited from increasing dividends on its common stock and from making certain repurchases of equity securities, including its common stock, without the U.S. Treasury's consent. Furthermore, as long as the Series A Preferred Stock was outstanding, dividend payments and repurchases or redemptions relating to

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certain equity securities, including the Company's common stock, were prohibited until all accrued and unpaid dividends were paid on the Series A Preferred Stock.

In order to participate in the Capital Purchase Program, financial institutions were required to adopt certain standards for executive compensation and corporate governance. These standards generally applied to the Chief Executive Officer, Chief Financial Officer and the three next most highly compensated senior executive officers. The standards included: (i) ensuring that incentive compensation for senior executives does not encourage unnecessary and excessive risks that threaten the value of the financial institution; (ii) requiring clawback of any bonus or incentive compensation paid to a senior executive based on statements of earnings, gains or other criteria that are later proven to be materially inaccurate; (iii) prohibiting golden parachute payments to senior executives; and (iv) agreeing not to deduct for tax purposes executive compensation in excess of $500,000 for these senior executives.

ARRA includes a wide variety of programs intended to stimulate the economy and provide for extensive infrastructure, energy, health, and education needs. ARRA imposes certain additional, more stringent executive compensation and corporate expenditure limits on all current and future TARP recipients until the U.S. Treasury is repaid, which is permitted under ARRA without penalty and without the need to raise new capital, subject to the U.S. Treasury's consultation with the recipient's appropriate regulatory agency.

The executive compensation standards under ARRA include, but are not limited to: (i) prohibitions on bonuses, retention awards and other incentive compensation, other than restricted stock grants which do not fully vest during the TARP period up to one-third of an employee's total annual compensation; (ii) prohibitions on golden parachute payments for departure from a company; (iii) an expanded clawback of bonuses, retention awards, and incentive compensation if payment is based on materially inaccurate statements of earnings, revenues, gains or other criteria; (iv) prohibitions on compensation plans that encourage manipulation of reported earnings; (v) retroactive review of bonuses, retention awards and other compensation previously provided by TARP recipients if found by the U.S. Treasury to be inconsistent with the purposes of TARP or otherwise contrary to the public interest; (vi) establishment of a companywide policy regarding "excessive or luxury expenditures," and (vii) inclusion in a participant's proxy statements for annual stockholder meetings of a non-binding "Say on Pay" stockholder vote on the compensation of executives.

The Company complied with the executive compensation requirements through March 7, 2012, the date of the Company's repurchase of the Series A Preferred Stock, and has certified as to such compliance in the exhibits attached to this report pursuant to Section 111(b) of EESA.

On March 7, 2012, the Company repurchased all shares of the Series A Preferred Stock in the aggregate amount of $40 million and paid a final dividend to the U.S. Treasury of $122,000. At the time the Company repurchased the Series A Preferred Stock, it did not repurchase the related warrant. The warrant was outstanding as of the date of this report. For complete discussion and disclosure see "*Management's Discussion and Analysis of Financial Condition and Results of Operations Capital Resources*" presented elsewhere in this report.

Supervision and Regulation

Introduction

Banking is a complex, highly regulated industry. The primary goals of the regulatory scheme are to maintain a safe and sound banking system, protect depositors and the Federal Deposit Insurance Corporation's ("FDIC") insurance fund, and 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

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management decisions and general economic conditions, but also by the requirements of applicable state and federal statues, 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 by the Federal Reserve. Under the BHCA, HCC is subject to 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 3700 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.

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 certain restrictions, including compliance with Sections 23A and 23B of the Federal Reserve Act and their implementing regulations. 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.

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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 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. 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.

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, or no other person will own a greater percentage of that class of voting securities immediately after the acquisition. Our common stock is registered under Section 12 of the Exchange Act.

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 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.

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. Dodd-Frank

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eliminates interstate branching restrictions that were implemented as part of the Interstate Banking Act, and removes many restrictions on de novo interstate branching by national and state chartered banks.

In 1995, California enacted legislation to implement important provisions of the Interstate Banking Act discussed above and to repeal California's previous interstate banking laws, which were largely preempted by the Interstate Banking Act.

The changes effected by the Interstate Banking Act and California laws have increased competition in the environment in which the Company operates to the extent that out of state financial institutions directly or indirectly enter the Company's market areas. It appears that the Interstate Banking Act has contributed to accelerated consolidation within the banking industry.

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 not and has no present plans to submit notice to the Federal Reserve to be 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.

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The Sarbanes Oxley Act of 2002. The Sarbanes Oxley Act of 2002 ("SOX") became effective on July 30, 2002, and represents the most far reaching corporate and accounting reform legislation since the enactment of the Securities Act of 1933 and the Exchange Act. SOX is intended to provide a permanent framework that improves the quality of independent 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.

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. 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 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. Dodd-Frank expanded definitions and restrictions on transactions with affiliates and insiders under Section 23A and 23B and also lending limits for derivative transactions, repurchase agreements and securities lending and borrowing transactions.

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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, 2011, 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.

Other Consumer Protection Laws and Regulations. The bank regulatory agencies are increasingly focusing attention on compliance with consumer protection laws and regulations. Banks have been advised to carefully monitor compliance with various consumer protection laws and regulations. The Federal Interagency Task Force on Fair Lending issued a policy statement on discrimination in home mortgage lending describing three methods that federal agencies will use to prove discrimination: overt evidence of discrimination, evidence of disparate treatment, and evidence of disparate impact. In addition to CRA and fair lending requirements, HBC is subject to numerous other federal consumer protection statutes and regulations. Due to heightened regulatory concern related to compliance with consumer protection laws and regulations generally, HBC may incur additional compliance costs or be required to expend additional funds for investments in the local communities it serves.

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

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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, 2011.

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 except as provided in HBC's policies and procedures. 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. On October 26, 2001, President Bush signed the USA Patriot Act of 2001 (the "Patriot Act"). Enacted in response to the terrorist attacks on September 11, 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 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.

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;
- 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

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orders or prompt corrective action orders to take corrective action and cease unsafe and unsound practices;

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 our 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 and all non-interest-bearing transaction accounts are insured through December 31, 2012. 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. Due to the increased number of bank failures and losses incurred by DIF, as well as the recent extraordinary programs in which the FDIC has been involved to support the banking industry generally, the FDIC's DIF was substantially depleted and the FDIC has incurred substantially increased operating costs. In November, 2009, the FDIC adopted a requirement for institutions to prepay in 2009 their estimated quarterly risk-based assessments for the fourth quarter of 2009 and for all of 2010, 2011, and 2012. HBC was exempted from the prepayment requirement by the FDIC.

As required by Dodd-Frank, the FDIC adopted a new DIF restoration plan which became effective on January 1, 2011. Among other things, the plan: (i) raises the minimum designated reserve ratio, which the FDIC is required to set each year, to 1.35% (from the former minimum of 1.15%) and removes the upper limit on the designated reserve ratio (which was formerly capped at 1.5%) and consequently on the size of the DIF; (ii) requires that the fund reserve ratio reach 1.35% by September 30, 2020; (iii) eliminates the requirement that the FDIC provide dividends from the DIF when the reserve ratio is between 1.35% and 1.5%; and (iv) continues the FDIC's authority to declare dividends when the reserve ratio at the end of a calendar year is at least 1.5%, but grants the FDIC sole discretion in determining whether to suspend or limit the declaration or payment of dividends. The FDIA continues to require that the FDIC's Board of Directors consider the appropriate level for the designated reserve ratio annually and, if changing the designated reserve ratio, engage in notice-and-comment rulemaking before the beginning of the calendar year. The FDIC has set a long-term goal of getting its reserve ratio up to 2% of insured deposits by 2027. In connection with these changes, we expect our FDIC deposit insurance premiums to increase.

On February 7, 2011, the FDIC approved a final rule, as mandated by Dodd-Frank, changing the deposit insurance assessment system from one that is based on total domestic deposits to one that is based on average consolidated total assets minus average tangible equity. In addition, the final rule creates a scorecard-based assessment system for larger banks (those with more than $10 billion in assets) and suspends dividend payments if the DIF reserve ratio exceeds 1.5%, but provides for decreasing assessment rates when the DIF reserve ratio reaches certain thresholds. Larger insured depository institutions will likely pay higher assessments to the DIF than under the old system. Additionally, the final rule includes a new adjustment for depository institution debt whereby an institution would pay an additional premium equal to 50 basis points on every dollar of long-term, unsecured debt held as an asset that was issued by another insured depository institution (excluding debt guaranteed under the Transaction Account Guaranty Program) to the extent that all such debt exceeds 3% of the other insured depository institution's Tier 1 capital. The new rule became effective for the quarter beginning April 1, 2011.

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Our FDIC insurance expense totaled $1.3 million for 2011. FDIC insurance expense includes deposit insurance assessments and Financing Corporation ("FICO") assessments related to outstanding FICO bonds to fund interest payments on bonds to recapitalize the predecessor to the DIF. These assessments will continue until the FICO bonds mature in 2017. The FICO assessment rates, which are determined quarterly, was 0.00250% of insured deposits for the first quarter of fiscal 2011 and 0.00170% of average total assets less average tangible equity for the second quarter of 2011, and 0.00165% of average total assets less average tangible equity for the third quarter of 2011. As of the date of this report, the Company had not received the FICO assessment for the fourth quarter of 2011.

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.

Capital Adequacy Requirements

Bank holding companies and banks are subject to various regulatory capital requirements administered by state and federal banking agencies. Increased capital requirements are expected as a result of expanded authority set forth in Dodd-Frank and the Basel III international supervisory developments discussed below. Capital adequacy guidelines and, additionally for banks, prompt corrective action regulations involve quantitative measures of assets, liabilities, and certain off-balance sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators about components, risk weighting, and other factors. *See "Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations Capital Resources."*

The current risk-based capital guidelines for bank holding companies and banks adopted by the federal banking agencies are intended to provide a measure of capital that reflects the degree of risk associated with a banking organization's operations for both transactions reported on the balance sheet as assets, such as loans, and those recorded as off-balance sheet items, such as commitments, letters of credit and recourse arrangements. The risk-based capital ratio is determined by classifying assets and certain off-balance sheet financial instruments into weighted categories, with higher levels of capital being required for those categories perceived as representing greater risks and dividing its qualifying capital by its total risk-adjusted assets and off-balance sheet items. Bank holding companies and banks engaged in significant trading activity may also be subject to the market risk capital guidelines and be required to incorporate additional market and interest rate risk components into their risk-based capital standards.

Qualifying capital is classified depending on the type of capital:

"Tier 1 capital" currently includes common equity and trust preferred securities, subject to certain criteria and quantitative limits. The capital received from trust preferred offerings also qualifies as Tier 1 capital, subject to the new provisions of Dodd-Frank. Under Dodd-Frank, depository institution holding companies with more than $15 billion in total consolidated assets as of December 31, 2009, will no longer be able to include trust preferred securities as Tier 1 regulatory capital after the end of a three-year phase-out period beginning 2013, and would need to replace any outstanding trust preferred securities issued prior to May 19, 2010 with qualifying Tier 1

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regulatory capital during the phase-out period. For institutions like HCC with less than $15 billion in total consolidated assets, existing trust preferred capital will still qualify as Tier 1. Small bank holding companies with less than $500 million in assets could issue new trust preferred which could still qualify as Tier 1; however, the market for any new trust preferred capital raises is uncertain.

"Tier 2 capital" includes hybrid capital instruments, other qualifying debt instruments, a limited amount of the allowance for loan and lease losses, and a limited amount of unrealized holding gains on equity securities. Following the phase-out period under Dodd-Frank, trust preferred securities will be treated as Tier 2 capital for those financial institutions with consolidated assets in excess of $15 billion.

"Tier 3 capital" consists of qualifying unsecured debt.

The sum of Tier 2 and Tier 3 capital may not exceed the amount of Tier 1 capital.

Under the current capital guidelines, there are three fundamental capital ratios: a total risk-based capital ratio, a Tier 1 risk-based capital ratio and a Tier 1 leverage ratio. To be deemed "well capitalized" a bank must have a total risk-based capital ratio and a Tier 1 risk-based capital ratio and a Tier 1 leverage ratio of at least 10% and 6%, respectively. At December 31, 2011, the respective capital ratios of HCC and HBC exceeded the minimum percentage requirements to be deemed "well-capitalized" under the regulatory framework for prompt corrective action. As of December 31, 2011, HBC's total risk-based capital ratio was 19.7% and its Tier 1 risk-based capital ratio was 18.5%. As of December 31, 2011, HCC's total risk-based capital ratio was 21.9% and its Tier 1 risk-based capital ratio was 20.6%.

HCC and HBC are also required to comply with minimum leverage ratio requirements. The leverage ratio is the ratio of a banking organization's Tier 1 capital to its total adjusted quarterly average assets (as defined for regulatory purposes). The requirements necessitate a minimum leverage ratio of 3.0% for bank holding companies and banks that either have the highest supervisory rating or have implemented the appropriate federal regulatory authority's risk-adjusted measure for market risk. All other bank holding companies and banks are required to maintain a minimum leverage ratio of 4.0%, unless a different minimum is specified by an appropriate regulatory authority. For a depository institution to be considered "well capitalized" under the regulatory framework for prompt corrective action, its leverage ratio must be at least 5.0%. As of December 31, 2011, HBC's leverage capital ratio was 13.7%, and HCC's leverage capital ratio was 15.3%, both ratios exceeding regulatory minimums.

The federal banking agencies may change existing capital guidelines or adopt new capital guidelines in the future and have required many banks and bank holding companies subject to enforcement actions to maintain capital ratios in excess of the minimum ratios otherwise required to be deemed well capitalized, in which case institutions may no longer be deemed well capitalized and may therefore be subject to restrictions on taking brokered deposits.

Basel Accords

The federal bank regulatory authorities' risk-based capital guidelines are based upon the 1988 capital accord (referred to as "Basel I") of the International Basel Committee on Banking Supervision ("Basel Committee"). The Basel Committee is a committee of central banks and bank supervisors/regulators from the major industrialized countries that develops broad policy guidelines for use by each country's supervisors in determining the supervisory policies they apply. A new framework and accord referred to as Basel II evolved from 2004 to 2006 out of the efforts to revise capital adequacy standards for internationally active banks. Basel II emphasizes internal assessment of credit, market and operational risk; supervisory assessment and market discipline in determining minimum capital requirements and became mandatory for large or "core" international banks outside the United States in 2008 (total assets of $250 billion or more or consolidated foreign exposures of $10 billion or more). Basel II was optional for others, and if adopted, must first be complied with in a "parallel run" for two years along with the existing

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Basel I standards. The Company is not required to comply with Basel II and has not elected to apply the Basel II standards.

The United States federal banking agencies issued a proposed rule for banking organizations that do not use the "advanced approaches" under Basel II. While this proposed rule generally parallels the relevant approaches under Basel II, it diverges where United States markets have unique characteristics and risk profiles. A definitive final rule has not yet been issued. The United States banking agencies indicated, however, that they would retain the minimum leverage requirement for all United States banks.

In June 2008, the federal banking agencies issued a proposed rule for banking organizations that do not use the "advanced approaches" of Basel II with the option to adopt a method to determine required regulatory capital that is more risk sensitive than the current Basel I-based rules. The proposed standardized framework addresses: (i) expanding the number of risk-weight categories to which credit exposures may be assigned; (ii) using loan-to-value ratios to risk weight most residential mortgages to enhance the risk sensitivity of the capital requirement; (iii) providing a capital charge for operational risk using the Basic Indicator Approach under the international Basel II capital accord; (iv) emphasizing the importance of a bank's assessment of its overall risk profile and capital adequacy; and (v) providing for comprehensive disclosure requirements to complement the minimum capital requirements and supervisory process through market discipline. A definitive final rule has not been issued. The United States banking agencies indicated, however, that they would retain the minimum leverage requirement for all United States banks.

In response to the economic and financial industry crisis, the Basel Committee on Banking Supervision and their oversight body the Group of Central Bank Governors and Heads of Supervision ("GHOS") set out in late 2009 to work on global initiatives to strengthen the financial regulatory system. In July 2010, the GHOS agreed on key design elements and in September 2010 agreed to transition and implementation measures. This reform package is known as Basel III, and it is designed to strengthen the regulation, supervision and risk management of the banking sector. In particular, Basel III strengthens existing capital requirements and introduces a global liquidity standard. It is expected that implementation of the higher minimum capital requirements under Basel III will begin on January 1, 2013 as member countries must implement new laws and regulations to implement the Basel III rules.

Basel III provides for increases in the minimum Tier 1 common equity ratio and the minimum requirement for the Tier 1 capital ratio. Basel III additionally includes a "capital conservation buffer" on top of the minimum requirement designed to absorb losses in periods of financial and economic distress; and an additional required countercyclical buffer percentage to be implemented according to a particular nation's circumstances. These capital requirements are further supplemented under Basel III by a non-risk-based leverage ratio.

The Basel III liquidity proposals have three main elements: (i) a "liquidity coverage ratio" designed to meet the bank's liquidity needs over a 30-day time horizon under an acute liquidity stress scenario; (ii) a "net stable funding ratio" designed to promote more medium and long-term funding over a one-year time horizon; and (iii) a set of monitoring tools that the Basel Committee indicates should be considered as the minimum types of information that banks should report to supervisors.

Final provisions to the Basel Committee's Basel III proposals are projected to be implemented by December 31, 2012. Implementation of Basel III in the United States will require regulations and guidelines by United States banking regulators, which may differ in significant ways from the recommendations published by the Basel Committee. It is unclear how United States banking regulators will define "well-capitalized" in their implementation of Basel III and to what extent and when smaller banking organizations in the United States will be subject to these regulations and guidelines. Basel III standards, if adopted, would lead to significantly higher capital requirements, higher capital charges and more restrictive leverage and liquidity ratios.

Although Basel III is intended to be implemented by participating countries for large, internationally active banks, its provisions are likely to be considered by United States banking regulators in developing new regulations applicable to other banks in the United States, including HBC. United States banking regulators must also implement Basel III in conjunction with the provisions of Dodd-Frank. The regulations ultimately applicable to the Company may be substantially different from the Basel III final framework. Requirements to maintain higher levels of capital or to maintain higher levels of liquid assets could adversely impact the Company's net income and return on equity.

Prompt Corrective Action Provisions

The FDIA provides a framework for regulation of depository institutions and their affiliates, including parent holding companies, by their federal banking regulators. Among other things, it requires the relevant federal banking regulator 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);

- "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.

An institution may be downgraded to, or deemed to be in, a capital category that is lower than indicated by its capital ratios if it is determined to be in an unsafe or unsound condition or if it receives an unsatisfactory examination rating with respect to certain matters.

The FDIA generally prohibits a depository institution from making any capital distributions (including payment of a dividend) or paying any management fee to its parent holding company if the depository institution would thereafter be "undercapitalized." "Undercapitalized" institutions are subject to growth limitations and are required to submit a capital restoration plan. The regulatory agencies may not accept such a plan without determining, among other things, that the plan is based on realistic assumptions and is likely to succeed in restoring the depository institution's capital. In addition, for a capital restoration plan to be acceptable, the depository institution's parent holding company must guarantee that the institution will comply with such capital restoration plan. The bank holding company must also provide appropriate assurances of performance. The aggregate liability of the parent holding company is limited to the lesser of (i) an amount equal to 5.0% of the depository institution's total assets at the time it became undercapitalized; and (ii) the amount which is necessary (or would have been necessary) to bring the institution into compliance with all capital standards applicable with respect to such institution as of the time it fails to comply with the plan. If a depository institution fails to submit an acceptable plan, it is treated as if it is "significantly undercapitalized." "Significantly undercapitalized" depository institutions may be subject to a number of requirements and restrictions, including orders to sell sufficient voting stock to become "adequately capitalized," requirements to reduce total assets, and cessation of receipt of deposits from correspondent banks. "Critically undercapitalized" institutions are subject to the appointment of a receiver or conservator.

The appropriate federal banking agency may, under certain circumstances, reclassify a well-capitalized insured depository institution as adequately capitalized. The FDIA provides that 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.

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 income 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 powers 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 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 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.

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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.

Under the terms of our trust preferred financings, including our related subordinated debentures, we cannot declare or pay any dividends or distributions (other than stock dividends) on, or redeem, purchase, acquire or make a liquidation payment with respect to, any shares of our capital stock if: (i) an event of default under any of the subordinated debenture agreements has occurred and is continuing; or (ii) if we give notice of our election to begin an extension period whereby we may defer payment of interest on the trust preferred securities for a period of up to sixty consecutive months as long as we are in compliance with all covenants of the agreement.

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

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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 in the aftermath of the economic downturn. 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.

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, 2011, the Company had 189 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.

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 has been and may continue to be adversely affected by conditions in the financial markets and economic conditions generally.

Negative developments in 2008 and 2009 in the financial services industry have resulted in uncertainty in the financial markets in general and a related general economic downturn, which have continued through 2011. In addition, as a consequence of the recent U.S. recession, businesses across a wide range of industries have faced serious difficulties due to the decrease in consumer spending, reduced consumer confidence brought on by deflated home prices, among other things, and reduced liquidity in the credit markets. Unemployment also increased significantly over the past several years.

As a result of these financial and economic crises, many lending institutions, including HCC, have experienced in recent years declines in the performance of their loans, including construction, land development and land loans, commercial real estate loans and other commercial and consumer loans. Moreover, competition among depository institutions for core deposits and quality loans has increased significantly. In addition, the values of real estate collateral supporting many commercial loans and home mortgages have declined and may continue to decline. Bank and bank holding company stock prices have been negatively affected, and the ability of banks and bank holding companies to raise capital or borrow in the debt markets has been more difficult compared to years prior to the economic downturn. As a result, bank regulatory agencies have been, and are expected to continue to be, very aggressive in responding to concerns and trends identified in examinations, including the issuance of formal or informal enforcement

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actions or orders. The impact of new legislation in response to these developments may negatively impact our operations by restricting our business operations, including our ability to originate or sell loans, and adversely impact our financial performance or our stock price.

In addition, further negative market developments may affect consumer confidence levels and may cause adverse changes in payment patterns, causing increases in delinquencies and default rates, which may impact our charge-offs and provision for loan losses. A worsening of these conditions would likely exacerbate the adverse effects of these difficult market conditions on us and others in the financial services industry.

Recent legislative and regulatory initiatives to address difficult market and economic conditions may not stabilize the United States banking system.

If current levels of market disruption and volatility continue or worsen, there can be no assurance that we will not experience an adverse effect, which may be material, on our ability to access capital and on our business, financial condition, results of operations, and cash flows. EESA, which established TARP, was signed into law on October 3, 2008. As part of TARP, the U.S. Treasury established the Capital Purchase Program to provide up to $700 billion of funding to eligible financial institutions through the purchase of capital stock and other financial instruments for the purpose of stabilizing and providing liquidity to the United States financial markets. Then, on February 17, 2009, ARRA was signed into law as a sweeping economic recovery package intended to stimulate the economy and provide for broad infrastructure, energy, health, and education needs.

There have been numerous actions undertaken in connection with or following EESA and ARRA by the Federal Reserve, Congress, U.S. Treasury, the SEC and the federal bank regulatory agencies in efforts to address the current liquidity and credit crisis in the financial industry that followed the subprime mortgage market meltdown which began in late 2007. These measures included homeowner relief that encourages loan restructuring and modification; the temporary increase in FDIC deposit insurance from $100,000 to $250,000; the establishment of significant liquidity and credit facilities for financial institutions and investment banks; the lowering of the Federal funds rate; emergency action against short selling practices; a temporary guaranty program for money market funds; the establishment of a commercial paper funding facility to provide back-stop liquidity to commercial paper issuers; and coordinated international efforts to address illiquidity and other weaknesses in the banking sector. The purpose of these legislative and regulatory actions is to help stabilize the United States banking system. EESA, ARRA and the other regulatory initiatives described above may not have their desired effects. If the volatility in the markets continues and economic conditions fail to improve or worsen, the Company's business, financial condition and results of operations could be materially and adversely affected.

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

Recent government efforts to strengthen the U.S. financial system have resulted in the imposition of additional regulatory requirements, including expansive financial services regulatory reform legislation. Dodd-Frank sets out sweeping regulatory changes. Changes imposed by Dodd-Frank include, among others: (i) new requirements on banking, derivative and investment activities, including modified capital requirements, the repeal of the prohibition on the payment of interest on business demand accounts, and debit card interchange fee requirements; (ii) corporate governance and executive compensation requirements; (iii) enhanced financial institution safety and soundness regulations, including increases in assessment fees and deposit insurance coverage; and (iv) the establishment of new regulatory bodies, such as the Bureau of Consumer Financial Protection. Certain provisions are effective immediately; however, much of the Financial Reform Act is subject to further rulemaking and/or studies and will take effect over several years, making it difficult to anticipate the overall financial impact on us and the financial services industry more generally. Nonetheless, we anticipate increased costs associated with these new regulations.

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Current and future legal and regulatory requirements, restrictions and regulations, including those imposed under 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 accompanying rules and may make it more difficult for us to attract and retain qualified executive officers and employees.

The FDIC's restoration plan and the related increased assessment rate could adversely affect our earnings.

As a result of a series of financial institution failures and other market developments, the deposit insurance fund, or DIF, of the FDIC has been significantly depleted and reduced the ratio of reserves to insured deposits. As a result of recent economic conditions and the enactment of Dodd-Frank, the FDIC has increased the deposit insurance assessment rates and thus raised deposit premiums for insured depository institutions. If these increases are insufficient for the DIF to meet its funding requirements, further special assessments or increases in deposit insurance premiums may be required which we may be required to pay. 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, we may be required to pay even higher FDIC premiums than the recently increased levels. Any future additional assessments, increases or required prepayments in FDIC insurance premiums may materially adversely affect our results of operations.

The impact of the new Basel III capital standards may impose enhanced capital adequacy standards on us.

On September 12, 2010, the Group of Governors and Heads of Supervision, the oversight body of the Basel Committee, announced agreement on the calibration and phase-in arrangements for a strengthened set of capital requirements, known as Basel III, which were approved in November 2010 by the G20 leadership. Basel III increases the minimum Tier 1 common equity ratio to 4.5%, net of regulatory deductions, and introduces a capital conservation buffer of an additional 2.5% of common equity to risk-weighted assets, raising the target minimum common equity ratio to 7%. Basel III increases the minimum Tier 1 capital ratio to 8.5% inclusive of the capital conservation buffer, increases the minimum total capital ratio to 10.5% inclusive of the capital buffer and introduces a countercyclical capital buffer of up to 2.5% of common equity or other fully loss absorbing capital for periods of excess credit growth. Basel III also introduces a non-risk adjusted Tier 1 leverage ratio of 3%, based on a measure of total exposure rather than total assets, and new liquidity standards. The Basel III capital standards will be phased in from January 1, 2013 until January 1, 2019, and it is not yet known how these standards will be implemented by United States regulators generally, or how they will be applied to banks of our size. 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.

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 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.

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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. Due to recent economic conditions affecting the real estate market, many lending institutions, including us, have experienced substantial declines in the performance of their loans, including construction, land development loans and land loans. The value of real estate collateral supporting many construction and land development loans, land loans, commercial loans and multi family loans have declined and may continue to decline. Recent negative developments in the financial industry and credit markets may continue to adversely impact our financial condition and results of operations.

Our interest expense may 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. As a result, beginning on July 21, 2011, financial institutions could commence offering interest on demand deposits to compete for clients. 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.

In addition, we evaluate all loans identified 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 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. 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 allowance for loan losses. Future additions to the allowance may also be required based on changes in the financial condition of borrowers, such as changes resulting from the current, and potentially worsening, economic conditions or as a result of incorrect assumptions by management in determining the 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.

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

At December 31, 2011, nonperforming loans, including nonaccrual loans held-for-sale, were 2.20% of the total loan portfolio and 1.29% of total assets. Nonperforming assets adversely affect our earnings in various ways. Until economic and market conditions improve, we may continue to incur losses relating to an increase in nonperforming assets. 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 loss. 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. If the current economic and market conditions persist or worsen, it is likely that we will experience future increases in nonperforming assets, particularly if we are unsuccessful in our efforts to reduce our classified assets, which would have a significant adverse effect on our business.

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, 2011, we recorded a $4.5 million provision for loan losses, charged-off $10.9 million of loans, and recovered $1.9 million of loans. Since 2008 there has been 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 reflects declining prices in real estate, higher levels of inventories of homes and higher vacancies in commercial and industrial properties, all of which have contributed to financial strain on real estate developers and suppliers. At December 31, 2011, we had $311.5 million in commercial and residential real estate loans and $23.0 million in land and construction real estate loans, excluding loans held-for-sale, of which $2.1 million and $3.3 million, respectively, were on nonaccrual. Construction loans and commercial real estate loans comprise a substantial portion of our nonperforming assets. Continued 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. Our net interest income (including net interest spread and margin) and ultimately our earnings are impacted by changes in interest rates and monetary policy. 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.

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, 2011, 33% 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.

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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 meet our cash obligations which may impair our ability to fulfill our obligations.

As a holding company, dividends from our subsidiary bank provide a substantial portion of our cash flow used to service the interest payments on our trust preferred securities, dividends on our preferred stock and other obligations, including any cash dividends on our common stock. Various statutory provisions restrict the amount of dividends HBC can pay to HCC without regulatory approval. HBC's ability to pay dividends to HCC is also limited by the California Financial Code. *See "Item 1 Business-Supervision and Regulation Dividends."*

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. The ongoing liquidity crisis and the loss of confidence in financial institutions may increase our cost of funding and limit our access to some of our customary sources of capital, including, but not limited to, inter-bank borrowings, repurchase agreements and borrowings from the discount window of the Federal Reserve.

We cannot assure you 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.

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

A further downturn in our real estate markets 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, 2011, approximately $311.5 million, or 41% of our loan portfolio, was secured by various forms of real estate, including residential and commercial real estate. Included in the $311.5 million of loans secured by real estate were $157.2 million (or 51%) of owner-occupied loans. The real estate securing our loan portfolio is concentrated in California which has experienced a significant decline in real estate values. There have been adverse developments affecting real estate values in one or more of our markets. 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, 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, continue to 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.

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, 2011, land and construction loans, including land acquisition and development total $23.0 million or 3% of our loan portfolio. This amount was comprised of 4% owner occupied and 96% non-owner occupied construction and land loans. At December 31, 2011, there were no unfunded amounts in the land and construction real estate loan portfolio. 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.

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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 supposed, and if a default occurs we may not recover the outstanding balance of the loan.

We must effectively manage our growth strategy.

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.

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, 2011, we had a net deferred tax asset of $21.9 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 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. Increased competition in our markets may result in reduced loans and deposits.

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

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services. The banking business in our primary market areas is very competitive, and the level of competition facing us may increase further, which may limit our asset growth and financial results.

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

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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 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 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 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.

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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 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.

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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 or exercise of the warrant issued to the U.S. Treasury 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 the existing holders of our common stock will be diluted to the extent the warrant issued to the U.S. Treasury is exercised. The shares of common stock underlying the warrant represent approximately 2% of the shares of our common stock outstanding as of December 31, 2011. Although the U.S. Treasury has agreed to not vote any of the common shares it receives upon exercise of the warrant, a transferee of any portion of the warrant or of any common shares acquired upon exercise of the warrant is not bound by this restriction. The terms of the warrant include an anti-dilution adjustment which provides that, if we issue common shares or securities convertible or exercisable into, or exchangeable for, common shares at a price that is less than 90% of the market price of such shares on the last trading day preceding the date of the agreement to sell such shares, the number of common shares to be issued would increase and the per share price of common shares to be purchased pursuant to the warrant would decrease.

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 underlying the Series C Preferred Stock represent approximately 21% of the shares of our common stock outstanding on December 31, 2011.

Holders of our subordinated debt have rights that are senior to those of our common and preferred shareholders.

We have supported our continued growth through four issuances of trust preferred securities from four separate special purpose trusts and related issuance of subordinated debt to these trusts. At December 31, 2011, we had outstanding subordinated debt totaling $23.7 million. Payments of the principal and interest on the subordinated debt are fully and unconditionally guaranteed by us. Further, the accompanying subordinated debt we issued to the special purpose trusts are senior to our outstanding shares of common stock and preferred stock. As a result, we must make payments on the subordinated debt before any dividends can be paid on our common stock or preferred stock and, in the event of our bankruptcy, dissolution or liquidation, the holders of the subordinated debt must be satisfied before any distributions can be made on our preferred stock or common stock. We have the right to defer interest payments on our subordinated debt and the related trust preferred securities for up to five years, during which time no cash dividends may be paid on our common stock or preferred stock. In the event HCC does not have sufficient funds or HBC is unable to pay dividends to HCC, then we may be unable to pay the amounts due to the holders of the junior subordinated debt securities and we would then be unable to declare and pay any dividends on our common stock or preferred stock.

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. This may make it difficult for you to resell shares of common stock owned by you at times or at prices you find attractive.

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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 sales of common stock by existing shareholders and/or directors and executive officers;
- trends in our nonperforming assets;
- the costs and effectiveness of our efforts to reduce our classified assets;
- 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.

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, 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.

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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 acquiror 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 3077 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 175 E. El Camino Real in Mountain View, California 94040. The Company also has a loan production office located at 740 4th Street, Suite 114, Santa Rosa, CA 95404.

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 $60,272 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 $4,978 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 $14,300 and is subject to annual increases of 3% 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 8,300 square foot one-story commercial building, including the land, located at 387 Diablo Road in Danville, California. The Company also assumed a 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 $14,766 and is subject to annual increases of 3% until the lease expires on October 31, 2017.

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In August of 2007, the Company extended its lease for approximately 6,590 square feet in a one-story stand-alone office building located at 3077 Stevenson Boulevard in Fremont, California. The current monthly rent payment is $14,834 and is subject to annual increases of 3% until the lease expires on February 28, 2013. The Company has reserved the right to extend the term of the lease for one additional period of five years.

In February 2008, the Company extended its lease for approximately 4,840 square feet in a one-story multi-tenant shopping center located at 175 E. El Camino Real in Mountain View, California. The current monthly rent payment is $15,283 and is subject to annual increases, based on the Consumer Price Index of the Bureau of Labor Statistics as defined in the lease agreement. The lease expires on May 31, 2013; however, the Company has reserved the right to extend the term of the lease for one additional period of five years.

In June of 2008, the Company entered into a sublease agreement for 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 monthly rent payment is $18,228 and is subject to annual increases of 3% until the sublease expires on April 30, 2012. After the sublease has expired, occupancy will continue under a direct lease, also entered into in June of 2008. The monthly rent payment beginning on May 1, 2012 will be $24,501 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 December of 2008, 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 $5,770 and is subject to annual increases of 3% until the lease expires on November 30, 2013. 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 2011, the Company renewed its lease for approximately 250 square feet of office space located at 740 Fourth Street in Santa Rosa, California. The current monthly rent payment is $1,287 until the lease expires on October 7, 2012.

For additional information on operating leases and rent expense, refer to Note 5 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 *RESERVED*

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: Automated Trading Desk Financial Services, LLC, Fig Partners, LLC, LATOUR TRADING LLC, Cantor Fitzgerald & Co., Citadel Securities LLC, Citadel Derivatives Group LLC,

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Cowen and Company, LLC, Crowell, Weedon & Co., D.A. Davidson & Co., E*Trade Capital Markets Llc, Credit Suisse Securities (USA) LLC, Goldman, Sachs & Co., RODMAN & RENSHAW, LLC, Keefe, Bruyette & Woods, Inc., Barclays Capital Inc./Le, Merrill Lynch, Pierce, Fenner & Smith Incorporated, McAdams Wright Ragen, Inc., Knight Capital Americas, L.P., Nasdaq Execution Services, LLC., Pershing LLC, Raymond James & Associates, Inc., Sandler, O'Neill & Partners, L.P., Two Sigma Securities, LLC, Stifel, Nicolaus & Company, Incorporated, Susquehanna Financial Group, LLP, Susquehanna Capital Group, Timber Hill LLC, and UBS 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 2011 and 2010 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 High	Stock Price Low	Dividend Per Share
Year ended December 31, 2011:			
Fourth quarter	$ 5.20	$ 3.75	$
Third quarter	$ 5.14	$ 3.85	$
Second quarter	$ 5.44	$ 4.63	$
First quarter	$ 5.10	$ 4.27	$
Year ended December 31, 2010:			
Fourth quarter	$ 4.50	$ 3.49	$
Third quarter	$ 3.77	$ 3.36	$
Second quarter	$ 5.83	$ 3.55	$
First quarter	$ 4.48	$ 3.40	$

The closing price of our common stock on February 15, 2012 was $5.15 per share as reported by the NASDAQ Global Select Market.

As of February 15, 2012, there were approximately 700 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 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.

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We have supported our growth through the issuance of trust preferred securities from special purpose trusts and accompanying sales of subordinated debt to these trusts. The subordinated debt that we issued to the trusts is senior to our shares of common stock and Series C Preferred Stock. As a result, we must make payments on the subordinated debt before any dividends can be paid on our common stock and Series C Preferred Stock.

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, 2011 regarding equity compensation plans under which equity securities of the Company were authorized for issuance:

	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	**Weighted average exercise price of outstanding options, warrants and rights (b)**	**Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)**
Equity compensation plans approved by security holders	1,275,919(1)	$14.32	523,595(2)
Equity compensation plans not approved by security holders	N/A	N/A	N/A

(1) Consists of 137,419 options to acquire shares of common stock issued under the Company's 1994 stock option plan, and 1,138,500 options to acquire shares under the Company's Amended and Restated 2004 Equity Plan.

(2) Available under the Company's Amended and Restated 2004 Equity Plan.

Performance Graph

The following graph compares the stock performance of the Company from December 31, 2006 to December 31, 2011, 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.

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The following chart compares the stock performance of the Company from December 31, 2006 to December 31, 2011, 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.

	Period Ending					
Index	**12/31/06**	**12/31/07**	**12/31/08**	**12/31/09**	**12/31/10**	**12/31/11**
Heritage Commerce Corp*	100	69	42	15	11	34
S&P 500*	100	104	64	79	89	89
NASDAQ Total US*	100	110	65	94	110	108
NASDAQ Bank Index*	100	78	59	48	54	47

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

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ITEM 6 *SELECTED FINANCIAL DATA*

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,				
	2011	2010	2009	2008	2007
	(Dollars in thousands, except per share amounts and ratios)				
INCOME STATEMENT DATA:					
Interest income	$ 52,031	$ 55,087	$ 62,293	$ 75,957	$ 78,712
Interest expense	5,875	10,512	16,326	24,444	27,012
Net interest income before provision for loan losses	46,156	44,575	45,967	51,513	51,700
Provision for loan losses	4,469	26,804	33,928	15,537	(11)
Net interest income after provision for loan losses	41,687	17,771	12,039	35,976	51,711
Noninterest income	8,422	8,733	8,027	6,791	8,052
Noninterest expense	39,572	88,127	44,760	42,392	37,530
Income (loss) before income taxes	10,537	(61,623)	(24,694)	375	22,233
Income tax expense (benefit)	(834)	(5,766)	(12,709)	(1,387)	8,137
Net income (loss)	11,371	(55,857)	(11,985)	1,762	14,096
Dividends and discount accretion on preferred stock	(2,333)	(2,398)	(2,376)	(255)	
Net income (loss) available to common shareholders	$ 9,038	$ (58,255)	$ (14,361)	$ 1,507	$ 14,096
PER COMMON SHARE DATA:					
Basic net income (loss)(1)	$ 0.28	$ (3.64)	$ (1.21)	$ 0.13	$ 1.13
Diluted net income (loss)(2)	$ 0.28	$ (3.64)	$ (1.21)	$ 0.13	$ 1.12
Book value per common share(3)	$ 5.30	$ 4.73	$ 11.34	$ 12.38	$ 12.90
Tangible book value per common share(4)	$ 5.20	$ 4.61	$ 7.38	$ 8.37	$ 9.20
Pro forma tangible book value per share, assuming Series C Preferred Stock was converted into common stock(5)	$ 4.90	$ 4.41	$ 7.38	$ 8.37	$ 9.20
Weighted average number of shares outstanding basic	31,867,584	16,026,058	11,820,509	12,002,910	12,449,270
Weighted average number of shares outstanding diluted	31,871,394	16,026,058	11,820,509	12,039,776	12,566,801
Shares outstanding at period end	26,295,001	26,233,001	11,820,509	11,820,509	12,774,926
Pro forma common shares outstanding at period end, assuming Series C Preferred Stock was converted into common stock(6)	31,896,001	31,834,001	11,820,509	11,820,509	12,774,926
BALANCE SHEET DATA:					
Securities	$ 380,455	$ 232,165	$ 109,966	$ 104,475	$ 135,402
Net loans	$ 743,981	$ 820,845	$ 1,041,345	$ 1,223,624	$ 1,024,247
Allowance for loan losses	$ 20,700	$ 25,204	$ 28,768	$ 25,007	$ 12,218
Goodwill and other intangible assets	$ 2,491	$ 3,014	$ 46,770	$ 47,412	$ 48,153
Total assets	$ 1,306,194	$ 1,246,369	$ 1,363,870	$ 1,499,227	$ 1,347,472
Total deposits	$ 1,049,428	$ 993,918	$ 1,089,285	$ 1,154,050	$ 1,064,226
Securities sold under agreement to repurchase	$	$ 5,000	$ 25,000	$ 35,000	$ 10,900
Subordinated debt	$ 23,702	$ 23,702	$ 23,702	$ 23,702	$ 23,702
Note payable	$	$	$	$ 15,000	$
Short-term borrowings	$	$ 2,445	$ 20,000	$ 55,000	$ 60,000
Total shareholders' equity	$ 197,831	$ 182,152	$ 172,305	$ 184,267	$ 164,824
SELECTED PERFORMANCE RATIOS:(7)					
Return (loss) on average assets	0.89%	-4.17%	-0.83%	0.12%	1.18%
Return (loss) on average tangible assets	0.89%	-4.25%	-0.86%	0.13%	1.21%
Return (loss) on average equity	6.02%	-30.82%	-6.68%	1.15%	9.47%
Return (loss) on average tangible equity	6.11%	-35.66%	-9.06%	1.67%	11.43%
Net interest margin	3.94%	3.69%	3.53%	3.94%	4.86%
Efficiency ratio, excluding impairment of goodwill	72.51%	84.31%	82.90%	72.71%	62.81%
Average net loans (excludes loans held for sale) as a percentage of average deposits	75.91%	87.53%	98.98%	100.01%	84.06%

Average total shareholders' equity as a percentage of average total assets	14.82%	13.55%	12.46%	10.52%	12.47%
SELECTED ASSET QUALITY DATA:(8)					
Net loan charge-offs (recoveries) to average loans	1.12%	3.18%	2.59%	0.23%	-0.10%
Allowance for loan losses to total loans	2.71%	2.98%	2.69%	2.00%	1.18%
Nonperforming loans to total loans plus nonaccrual loans loans held-for-sale	2.20%	3.90%	5.83%	3.24%	0.33%
Nonperforming assets	$ 19,142	$ 34,399	$ 64,616	$ 41,101	$ 4,526
CAPITAL RATIOS:					
Total risk-based	21.9%	20.9%	12.9%	13.4%	12.5%
Tier 1 risk-based	20.6%	19.7%	11.6%	12.1%	11.5%
Leverage	15.3%	14.1%	10.1%	11.3%	11.1%

Notes:

1) Represents net income (loss) available to common shareholders divided by the average number of shares of common stock outstanding for the respective period. For years prior to 2009, earnings per share ("EPS") and weighted average shares outstanding have been adjusted retrospectively to apply new accounting guidance that became effective in 2009. Except for reducing basic EPS from $1.14 to $1.13 in 2007, this change in computation did not involve a sufficient number of shares to change basic or diluted EPS from amounts previously reported.

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2) Represents net income (loss) available to common shareholders, less net income allocated to Series C Preferred Stock, divided by the average number of shares of common stock and common stock-equivalents outstanding for the respective period.

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 and 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 and minus goodwill and other intangible assets divided by the number of shares of common stock outstanding at the end of period indicated, assuming Series C Preferred Stock was converted into 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, 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.

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 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. 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's customers are primarily closely held businesses and professionals.

Performance Overview

For the year ended December 31, 2011, net income was $11.4 million. The net income available to common shareholders was $9.0 million, or $0.28 per diluted common share, which included a reversal of the $3.7 million partial valuation allowance for deferred tax assets that was established in 2010. For the year ended December 31, 2010, the net loss was ($55.9) million and the net loss available to common shareholders was ($58.3) million, or ($3.64) per diluted common share, which included a non-cash goodwill impairment charge of $43.2 million and loan charge-offs of $13.9 million related to problem real estate loans transferred to loans held-for-sale in the second quarter of 2010.

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

The net interest margin increased 25 basis points to 3.94% for the year ended December 31, 2011, compared to 3.69% for the year ended December 31, 2010. The increase in the net interest margin for 2011 compared to 2010 was primarily due to an increase in the yields on loans and a decrease in rates paid on deposits. The net interest margin increased 16 basis points to 3.69% for the year ended December 31, 2010, compared with 3.53% for the year ended December 31, 2009. The increase in the net interest margin for 2010 compared to 2009 was primarily due to an increase in the yields on loans and securities and a decrease in rates paid on deposits and borrowings.

Net interest income increased 4% to $46.2 million for the year ended December 31, 2011, compared to $44.6 million for the year ended December 31, 2010, primarily due to an increase in the average balance of investment securities, and a decrease in the average balance and rates paid on interest-bearing liabilities, partially offset by a decrease in the average balance of loans. Net interest income decreased 3% to $44.6 million for the year ended December 31, 2010, compared to $46.0 million for the year ended December 31, 2009, primarily due to a decrease in loan balances.

The provision for loan losses was $4.5 million for the year ended December 31, 2011, compared to $26.8 million for the year ended December 31, 2010, and $33.9 million for the year ended December 31, 2009. The decrease in the provision for loan losses in 2011 compared to 2010 reflects a lower volume of classified and nonperforming loans and contraction of the loan portfolio. The decrease in the 2010 provision for loan losses compared to 2009 reflects the decline in the size of the loan portfolio and improvement in credit quality in the latter half of the year.

Noninterest income decreased 4% to $8.4 million for the year ended December 31, 2011, compared to $8.7 million for the year ended December 31, 2010. Noninterest income for 2011 included a $459,000 gain on sale of securities, compared to a $2.0 million gain on sale of securities in 2010, which was partially offset by an $887,000 loss on sale of other loans during 2010. Noninterest income increased by 9% in 2010 to $8.7 million, compared to $8.0 million in 2009, primarily due to a $2.0 million gain on the sale of securities in 2010, offset by an $887,000 loss on sale of other loans.

Noninterest expense was $39.6 million for the year ended December 31, 2011, compared to $44.9 million, excluding the $43.2 million impairment of goodwill, for the year ended December 31, 2010. Noninterest expense decreased for the year ended December 31, 2011 compared to the year ended December 31, 2010, primarily due to lower write-downs on loans held-for-sale, a decrease in salaries and benefits expense, lower professional fees and lower FDIC insurance premiums. Noninterest expense for the year ended December 31, 2009 was $44.8 million.

The efficiency ratio was 72.51% for the year ended December 31, 2011, compared to 84.31% for the year ended December 31, 2010, excluding the impairment of goodwill. The improvement was primarily due to lower noninterest expense as management continues to focus on controlling expenses and higher net interest income. The efficiency ratio for the year ended December 31, 2009 was 82.90%.

The income tax benefit for the year ended December 31, 2011 was $834,000, compared to an income tax benefit of $5.8 million for the year ended December 31, 2010, and an income tax benefit of $12.7 million for the year ended December 31, 2009. 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 difference in the effective tax rate compared to the combined Federal and state statutory tax rate of 42% is primarily the result of 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, goodwill impairment, and the valuation allowance.

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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 increased 49% to $453.3 million at December 31, 2011, compared to $304.3 million at December 31, 2010.

Total loans, excluding loans held-for-sale, decreased $81.5 million, or 10%, to $764.6 million at December 31, 2011, compared to $846.0 million at December 31, 2010. Land and construction loans decreased $39.3 million, or 63% to $23.0 million at December 31, 2011, compared to $62.4 million at December 31, 2010.

Classified assets decreased 35% to $59.5 million at December 31, 2011, compared to $91.8 million at December 31, 2010.

The allowance for loan losses at December 31, 2011 was $20.7 million, or 2.71% of total loans, representing 124.37% of nonperforming loans excluding nonaccrual loans in loans held-for-sale. The allowance for loan losses at December 31, 2010 was $25.2 million, or 2.98% of total loans, representing 81.10% of nonperforming loans excluding nonaccrual loans in loans held-for-sale.

Nonperforming assets decreased $15.3 million to $19.1 million, or 1.47% of total assets at December 31, 2011, compared to $34.4 million, or 2.76% of total assets at December 31, 2010.

Net loan charge-offs were $9.0 million for the year ended December 31, 2011, compared to $30.4 million for the year ended December 31, 2010.

Noninterest-bearing demand deposits increased 23% to $344.3 million at December 31, 2011, compared to $280.3 million at December 31, 2010.

Brokered deposits decreased 14% to $84.7 million at December 31, 2011, compared to $98.5 million at December 31, 2010.

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 19.90% at December 31, 2011, compared to 20.96% at December 31, 2010.

The loan to deposit ratio was 72.86% at December 31, 2011, compared to 85.12% at December 31, 2010.

Capital ratios substantially exceed regulatory requirements for a well-capitalized financial institution, both at the holding company and HBC. The leverage ratio at the holding company was 15.3%, with a Tier 1 risk-based capital ratio of 20.6%, and a total risk-based capital ratio of 21.9% at December 31, 2011. The leverage ratio for HBC was 13.7%, with a Tier 1 risk-based capital ratio of 18.5%, and a total risk-based capital ratio of 19.7% at December 31, 2011. The regulatory well-capitalized guidelines are a minimum of a 5% leverage ratio, a 6% Tier 1 risk-based capital ratio, and a 10% total risk-based capital ratio.

Significant 2011 Events

The Federal Reserve and DFI issued a joint order terminating the regulatory Written Agreement entered into on February 17, 2010, among HCC, HBC, the Federal Reserve and the DFI. Effective June 9, 2011, HCC and HBC are no longer be subject to the terms and conditions of the Written Agreement.

In November 2009, the Company announced that it was exercising its right to defer regularly scheduled interest payments on its $23.7 million of junior subordinated notes relating to its trust preferred securities. From the time it deferred interest payments, the Company accrued the expense of each deferred interest payment at the normal rate on a compounded basis. On June 24, 2011, the Company paid all of the

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deferred interest payments on its outstanding trust preferred subordinated debt securities in the amount of $3.9 million, which included all payments due through September 8, 2011. As a result of the June 2011 interest payment and the payment of regularly scheduled interest payments in the third and fourth quarters of 2011, the Company is current with respect to interest accrued on trust preferred subordinated debt securities.

On July 28, 2011, the Company's Board of Directors declared a dividend on its Series A Preferred Stock held by the U.S. Treasury in an aggregate amount of $4.2 million. The dividend was paid on August 1, 2011. Of the aggregate dividend declared and paid, $3.5 million was attributable to the dividend periods ending November 15, 2009 through May 15, 2011 and $172,000 was for interest on the deferred dividend payments, that had been previously accrued. The balance of $500,000 was the dividend payable for the period ending August 15, 2011.

The Company had net deferred tax assets of $27.4 million, net of a $3.7 million partial valuation allowance, as of December 31, 2010. The Company reversed the partial valuation allowance in 2011, based on the Company's estimate that it is more likely than not that the remaining net deferred tax assets will be realized. At December 31, 2011, the net deferred tax asset was $21.9 million.

The Company maintains life insurance policies for current and former directors and officers that are subject to split-dollar life insurance agreements. During the third quarter of 2011, participants in the split-dollar life insurance benefit plan agreed to amend their agreements. As a result of the amended agreements, among other items, the benefit plan liability was reduced from $6.4 million as of December 31, 2010 to $4.5 million as of December 31, 2011.

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. The Company had $84.7 million in brokered deposits at December 31, 2011, compared to $98.5 million at December 31, 2010. Deposits from title insurance companies, escrow accounts and real estate exchange facilitators decreased to $37.6 million at December 31, 2011, compared to $39.0 million at December 31, 2010. Certificates of deposit from the State of California totaled $50.0 million at December 31, 2011, compared to none at December 31, 2010. 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. Deposits at December 31, 2011 were $1.0 billion, compared to $993.9 million at December 31, 2010. At December 31, 2011, our reliance on noncore funding had improved with the ratio of noncore funding to total assets at 19.90%, compared to 20.96% at December 31, 2010.

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. Deposits in the CDARS program totaled $6.4 million at December 31, 2011, compared to $17.9 million at December 31, 2010.

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, 2011, we had $72.9 million in cash and cash equivalents and approximately $328.9 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 $290.2 million in unpledged securities available at December 31, 2011. Our loan to deposit ratio decreased to 72.86% at December 31, 2011, compared to 85.12% at December 31, 2010, primarily due to a reduction in the loan portfolio.

Lending

Our lending business originates primarily through our branch offices located in our primary market. The Company also has an additional SBA loan production office in Santa Rosa, California. The total loan portfolio remains well diversified with commercial and industrial ("C&I") loans accounting for 48% of the portfolio at December 31, 2011. Commercial and residential real estate loans accounted for 41% of the total loan portfolio at December 31, 2011, of which 51% were owner-occupied by businesses. We have actively lowered our exposure to land and construction loans and our overall credit risk on these portfolios has been reduced. Land and construction loans decreased $39.3 million to $23.0 million at December 31, 2011, compared to $62.3 million at December 31, 2010, and accounted for 3% of our total loan portfolio at December 31, 2011, compared to 7% at December 31, 2010. Consumer and home equity loans accounted for the remaining 8% of total loans at December 31, 2011. The yield on the loan portfolio was 5.32% for the year ended December 31, 2011, compared to 5.11% for the year ended December 31, 2010. Loans, excluding loans held-for-sale, decreased 10% to $764.6 million at December 31, 2011, compared to $846.0 million at December 31, 2010. The decline in gross loans for the year ended December 31, 2011 was primarily due to diminished loan demand, loan payoffs exceeding draw downs of loan commitments and the result of efforts to reduce classified loans. Lower volume of loan originations can be attributed in part to lower demand for certain types of credit as well as more selectivity with respect to the types of loans the Company chooses to originate.

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.

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

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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. Prior to February 15, 2011, the sale of SBA loans were subject to a warranty for a period of 90 days. In accordance with generally accepted accounting principles, the Company treated the SBA loans sold as secured borrowings during the warranty period. Effective February 15, 2011, the SBA no longer required a warranty period in loan sales agreements. Therefore, gains on loan sales completed after February 15, 2011 are recognized upon completion of the transaction.

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 decreased $5.4 million, for the year ended December 31, 2011, compared to the year ended December 31, 2010, excluding the impairment of goodwill, primarily due to lower salaries and benefits, FDIC deposit insurance premiums, professional fees, writedown of loans held-for-sale, and expenses related to foreclosed assets.

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.

Under the terms of the Capital Purchase Program with the U.S. Treasury, so long as our Series A Preferred Stock was outstanding, we were prohibited from increasing quarterly dividends on our common stock in excess of $0.08 per share, and from making certain repurchases of equity securities, including our common stock, without the U.S. Treasury consent until the third anniversary of the U.S. Treasury investment or until the U.S. Treasury had transferred all of the Series A Preferred Stock it purchased under the Capital Purchase Program to third parties. As long as the Series A Preferred Stock was outstanding, dividend payments and repurchases or redemptions relating to certain equity securities, including our common stock and the Series C Preferred Stock, were also prohibited until all accrued and unpaid dividends are paid on the Series A Preferred Stock, subject to certain limited exceptions. On November 6, 2009, we suspended dividend payments on our Series A Preferred Stock. On July 28, 2011, the Company's Board of Directors declared a dividend on its Series A Preferred Stock held by the U.S. Treasury in an aggregate amount of $4.2 million. The dividend was paid on August 1, 2011. Of the aggregate dividend declared and paid, $3.5 million was attributable to the dividend periods ending November 15, 2009 through May 15, 2011 and $172,000 was for interest on the deferred dividend payments, that have been previously accrued. The balance of $500,000 was the dividend payable for the period ending August 15, 2011.

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 will save us $2.0 million in annual dividends. At the time the Company repurchased the Series A Preferred Stock, it did not repurchase the related warrant. The warrant was outstanding as of the date of this report.

On June 21, 2010, the Company issued Series B Mandatorily Convertible Cumulative Perpetual Preferred Stock ("Series B Preferred Stock") and Series C Convertible Perpetual Preferred Stock ("Series C Preferred Stock") to a limited number of institutional investors for an aggregate amount of $75.0 million. HCC then downstreamed $40 million of the proceeds from the private placement to the capital of HBC.

After receiving shareholder approval in September 2010, the outstanding Series B Preferred Stock converted into approximately 14.4 million shares of the Company's common stock. The Series C Preferred Stock remains outstanding until its conversion to common stock upon the transfer of the Series C Preferred Stock in accordance with its terms. Holders of Series C Preferred Stock will receive dividends if and only to the extent dividends are paid to holders of common stock.

We have supported our growth through the issuance of trust preferred securities from special purpose trusts and accompanying sales of subordinated debt to these trusts. The subordinated debt that we issued to the trusts is senior to our shares of common stock and Series C Preferred Stock. As a result, we must make payments on the subordinated debt before any dividends can be paid on our common stock and Series C Preferred Stock. Under the terms of the subordinated debt, we may defer interest payments for up to five years. In November 2009, the Company announced that it was exercising its right to defer regularly scheduled interest payments on its $23.7 million of junior subordinated notes relating to its trust preferred securities. From the time it deferred interest payments, the Company accrued the expense of each deferred interest payment at the normal rate on a compounded basis. On June 24, 2011, the Company paid all of the deferred interest payments on its outstanding trust preferred subordinated debt securities in the amount of $3.9 million, which included all payments due through September 8, 2011. As a result of the June 2011 interest payment and the payment of regularly scheduled interest payments in the third and fourth quarters of 2011, the Company is current with respect to interest accrued on trust preferred subordinated debt securities.

At December 31, 2011, HBC's total risk-based capital ratio was 19.7%, compared to the 10% regulatory requirement for well-capitalized banks under the regulatory framework for prompt corrective actions. HBC's Tier 1 risk-based capital ratio of 18.5% and leverage ratio of 13.7% at December 31, 2011 also exceeded regulatory guidelines for well-capitalized banks under the prompt corrective actions framework. On a consolidated basis, the Company has a total risk-based capital ratio of 21.9%, a Tier 1 risk-based capital ratio of 20.6%, and a leverage ratio of 15.3% at December 31, 2011.

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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, 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,								
	2011			2010			2009		
	Average Balance	Interest Income/ Expense	Average Yield/ Rate	Average Balance	Interest Income/ Expense	Average Yield/ Rate	Average Balance	Interest Income/ Expense	Average Yield/ Rate
	(Dollars in thousands)								
Assets:									
Loans, gross(1)	$ 804,068	$ 42,769	5.32%	$ 971,025	$ 49,633	5.11%	$ 1,171,537	$ 58,602	5.00%
Securities	297,231	9,088	3.06%	148,069	5,236	3.54%	104,080	3,627	3.48%
Federal funds sold and interest-bearing deposits in other financial institutions	68,878	174	0.25%	89,083	218	0.24%	26,443	64	0.24%
Total interest earning assets	1,170,177	52,031	4.45%	1,208,177	55,087	4.56%	1,302,060	62,293	4.78%
Cash and due from banks	21,077			21,234			21,802		
Premises and equipment, net	8,022			8,742			9,311		
Goodwill and other intangible assets	2,762			24,609			47,105		
Other assets	73,172			75,216			59,666		
Total assets	$ 1,275,210			$ 1,337,978			$ 1,439,944		
Liabilities and shareholders' equity:									
Deposits:									
Demand, noninterest-bearing	$ 334,676			$ 265,546			$ 261,539		
Demand, interest-bearing	133,538	238	0.18%	153,618	341	0.22%	136,734	336	0.25%
Savings and money market	279,250	892	0.32%	297,257	1,440	0.48%	334,657	2,514	0.75%
Time deposits under $100	31,549	230	0.73%	37,889	496	1.31%	43,946	983	2.24%
Time deposits $100 and Over	131,756	1,298	0.99%	134,024	1,900	1.42%	155,475	2,813	1.81%
Time deposits CDARS	16,403	67	0.41%	18,252	159	0.87%	19,702	303	1.54%
Time deposits brokered	92,278	1,217	1.32%	155,558	3,750	2.41%	196,113	6,513	3.32%
Total interest-bearing deposits	684,774	3,942	0.58%	796,598	8,086	1.02%	886,627	13,462	1.52%
Total deposits	1,019,450	3,942	0.39%	1,062,144	8,086	0.76%	1,148,166	13,462	1.17%
Subordinated debt	23,702	1,871	7.89%	23,702	1,878	7.92%	23,702	1,933	8.15%
Securities sold under agreement to repurchase	712	24	3.37%	18,767	418	2.23%	28,822	787	2.73%
Note payable			N/A			N/A	2,507	82	3.27%
Short-term borrowings	933	38	4.07%	8,347	130	1.56%	24,940	62	0.25%
Total interest-bearing liabilities	710,121	5,875	0.83%	847,414	10,512	1.24%	966,598	16,326	1.69%
Total interest-bearing liabilities and demand, noninterest-bearing / cost of funds	1,044,797	5,875	0.56%	1,112,960	10,512	0.94%	1,228,137	16,326	1.33%
Other liabilities	41,473			43,776			32,417		
Total liabilities	1,086,270			1,156,736			1,260,554		
Shareholders' equity	188,940			181,242			179,390		
Total liabilities and shareholders' equity	$ 1,275,210			$ 1,337,978			$ 1,439,944		
Net interest income / margin		$ 46,156	3.94%		$ 44,575	3.69%		$ 45,967	3.53%

(1) Includes loans held-for-sale. Yields and amounts earned on loans include loan fees and costs. Nonaccrual loans are included in average balance.

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 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.

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Volume and Rate Variances

	2011 vs. 2010 Increase (Decrease) Due to Change in:			2010 vs. 2009 Increase (Decrease) Due to Change in:		
	Average Volume	Average Rate	Net Change	Average Volume	Average Rate	Net Change
	(Dollars in thousands)					
Income from the interest earning assets:						
Loans, gross	$ (8,890)	$ 2,026	$ (6,864)	$ (10,233)	$ 1,264	$ (8,969)
Securities	4,557	(705)	3,852	1,552	57	1,609
Federal funds sold and interest-bearing deposits in other financial institutions	(49)	5	(44)	154		154
Total interest income on interest earning assets	(4,382)	1,326	(3,056)	(8,527)	1,321	(7,206)
Expense from the interest-bearing liabilities:						
Demand, interest-bearing	(39)	(64)	(103)	40	(35)	5
Savings and money market	(59)	(489)	(548)	(166)	(908)	(1,074)
Time deposits under $100	(47)	(219)	(266)	(80)	(407)	(487)
Time deposits $100 and over	(29)	(573)	(602)	(308)	(605)	(913)
Time deposits CDARS	(8)	(84)	(92)	(12)	(132)	(144)
Time deposits brokered	(836)	(1,697)	(2,533)	(976)	(1,787)	(2,763)
Subordinated debt		(7)	(7)		(55)	(55)
Securities sold under agreement to repurchase	(608)	214	(394)	(225)	(144)	(369)
Notes payable				(82)		(82)
Short-term borrowings	(302)	210	(92)	(259)	327	68
Total interest expense on interest-bearing liabilities	(1,928)	(2,709)	(4,637)	(2,068)	(3,746)	(5,814)
Net interest income	$ (2,454)	$ 4,035	$ 1,581	$ (6,459)	$ 5,067	$ (1,392)

The Company's net interest margin, expressed as a percentage of average earning assets was 3.94% for 2011, an increase of 25 basis points compared to 3.69% for 2010, principally due to a higher yield on loans and a lower cost of deposits. The Company's net interest margin for 2010 increased 16 basis points compared to 3.53% for 2009, as yields on loans and securities increased and the costs of deposits and borrowings declined. The yield on interest earning assets decreased to 4.45% for 2011, compared to 4.56% for 2010, and 4.78% for 2009, primarily due to contraction in the loan portfolio. The cost of total deposits, including noninterest-bearing demand deposits, decreased to 0.39% for 2011, compared to 0.76% for 2010, and 1.17% for 2009, as a result of maturing higher-cost wholesale funding and a more cost-effective blend of core deposits.

Net interest income for the year ended December 31, 2011 increased $1.6 million to $46.2 million, compared to $44.6 million a year ago, primarily due to a an increase in the average balance of investment securities, and a decrease in the average balance and rates paid on interest-bearing liabilities, partially offset by a decrease in the average balance of loans. Net interest income for the year ended December 31, 2010 decreased $1.4 million to $44.6 million, compared to $46.0 million for the year ended December 31, 2009, primarily due to a decrease in average loan balances, partially offset by an increase in average investment securities, an increase in average Federal funds sold, and interest-bearing deposits, as well as a lower cost of funds.

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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.

For 2011, the Company had a provision for loan losses of $4.5 million, compared to a provision for loan losses of $26.8 million for 2010 and a provision for loan losses of $33.9 million for 2009. The significant decrease in the provision for loan losses in 2011 compared to 2010 and 2009 reflects the improvement in credit quality.

The allowance for loan losses represented 2.71%, 2.98% and 2.69% of total loans at December 31, 2011, 2010 and 2009, respectively. 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*."

Noninterest Income

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

	Year Ended December 31,			Increase (decrease) 2011 versus 2010		Increase (decrease) 2010 versus 2009	
	2011	**2010**	**2009**	**Amount**	**Percent**	**Amount**	**Percent**
	(Dollars in thousands)						
Service charges and fees on deposit accounts	$ 2,355	$ 2,228	$ 2,221	$ 127	6%	$ 7	0%
Servicing income	1,743	1,719	1,587	24	1%	132	8%
Increase in cash surrender value of life insurance	1,706	1,677	1,664	29	2%	13	1%
Gain on sale of SBA loans	1,461	1,058	1,306	403	38%	(248)	-19%
Gain on sale of securities	459	1,955	231	(1,496)	-77%	1,724	746%
Loss on sale of other loans		(887)		887	-100%	(887)	N/A
Other	698	983	1,018	(285)	-29%	(35)	-3%
Total	$ 8,422	$ 8,733	$ 8,027	$ (311)	-4%	$ 706	9%

The decrease in noninterest income was primarily due to a lower gain on sale of securities of $459,000 for 2011, compared to a $2.0 million gain on sale of securities, which was partially offset by an $887,000 loss on sale of other loans during 2010. The increase in noninterest income in 2010 compared to 2009 was primarily due to $2.0 million in gain on the sale of securities in 2010, partially offset by an $887,000 loss on

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the sale of problem loans. Other sources of noninterest income include loan servicing fees, service charges and fees, and the cash surrender value from company owned life insurance policies.

Historically, a significant percentage of the Company's noninterest income has been associated with its SBA lending activity, as gains on the sale of loans sold in the secondary market and servicing income from loans sold with servicing rights retained. During 2011, SBA loan sales resulted in a $1.5 million gain, compared to a $1.1 million gain on sale of SBA loans in 2010, and a $1.3 million gain on sale of SBA loans in 2009. The servicing assets that result from the sale 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 3.89% 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.

Noninterest Expense

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

	Year Ended December 31,			Increase (decrease) 2011 versus 2010		Increase (decrease) 2010 versus 2009	
	2011	2010	2009	Amount	Percent	Amount	Percent
	(Dollars in thousands)						
Salaries and employee benefits	$ 20,574	$ 21,234	$ 22,927	$ (660)	-3%	$ (1,693)	-7%
Occupancy and equipment	4,083	4,087	3,937	(4)	0 %	150	4 %
Professional fees	2,861	3,975	3,851	(1,114)	-28%	124	3 %
FDIC deposit insurance premiums	1,294	4,002	3,321	(2,708)	-68%	681	21 %
Software subscriptions	1,078	1,004	865	74	7 %	139	16 %
Low income housing investment losses	1,035	795	922	240	30 %	(127)	-14%
Insurance expense	941	1,007	639	(66)	-7%	368	58 %
Data processing	876	831	912	45	5 %	(81)	-9%
Advertising and promotion	435	395	406	40	10 %	(11)	-3%
Foreclosed assets expense	389	650	518	(261)	-40%	132	25 %
Writedown of loans held-for-sale	29	1,080		(1,051)	-97%	1,080	N/A
Impairment of goodwill		43,181		(43,181)	-100%	43,181	N/A
Other	5,977	5,886	6,462	91	2 %	(576)	-9%
Total	$ 39,572	$ 88,127	$ 44,760	$ (48,555)	-55%	$ 43,367	97 %

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

Noninterest Expense by Category

	2011		2010		2009	
	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
			(Dollars in thousands)			
Salaries and employee benefits	$ 20,574	52%	$ 21,234	24%	$ 22,927	51%
Occupancy and equipment	4,083	10%	4,087	5%	3,937	9%
Professional fees	2,861	7%	3,975	4%	3,851	9%
FDIC deposit insurance premiums	1,294	3%	4,002	5%	3,321	7%
Software subscriptions	1,078	3%	1,004	1%	865	2%
Low income housing investment losses	1,035	3%	795	1%	922	2%
Insurance expense	941	3%	1,007	1%	639	1%
Data processing	876	2%	831	1%	912	2%
Advertising and promotion	435	1%	395	0%	406	1%
Foreclosed assets expense	389	1%	650	1%	518	1%
Writedown of loans held-for-sale	29	0%	1,080	1%		0%
Impairment of goodwill		0%	43,181	49%		0%
Other	5,977	15%	5,886	7%	6,462	15%
Total	$ 39,572	100%	$ 88,127	100%	$ 44,760	100%

Noninterest expense for the year ended December 31, 2011 declined 12% to $39.6 million, compared to $44.9 million (excluding the $43.2 million impairment of goodwill) for the year ended December 31, 2010. The decrease in noninterest expense for the year ended December 31, 2011 was primarily due to lower write-downs on loans held-for-sale, a decrease in salaries and benefits expense, lower professional fees, lower FDIC insurance premiums and lower foreclosed assets expense. Salaries and employee benefits decreased $660,000, or 3%, for the year ended December 31, 2011 from the year ended December 31, 2010, primarily due to a reduction in staff implemented in the fourth quarter of 2010. Full-time equivalent employees were 189, 181, and 206 at December 31, 2011, 2010, and 2009, respectively. Professional fees decreased $1.1 million, or 28%, for the year ended December 31, 2011 compared to 2010 primarily due to a decrease in legal fees related to loan workouts and litigation and decreased expenses for bank regulatory compliance. FDIC deposit insurance premiums decreased $2.7 million, or 68%, for the year ended December 31, 2011 compared to 2010, due to a decrease in the FDIC deposit assessment rate. Foreclosed assets expense decreased $261,000 or 40%, for 2011, compared to 2010 due to a decrease in writedowns of foreclosed assets. The Company's low income housing investment losses increased $240,000, or 30%, to $1.0 million for 2011, compared to $795,000 for 2010.

Noninterest expense for the year ended December 31, 2010, excluding the impairment of goodwill, remained relatively flat at $44.9 million, compared to $44.8 million for the year ended December 31, 2009, as a decrease in salaries and benefits was offset by a $1.1 million writedown of loans held-for-sale and higher FDIC deposit insurance premiums. Salaries and employee benefits decreased $1.7 million, or 7%, for 2010, compared to 2009, primarily due to a reduction in workforce implemented in the fourth quarter of 2009, an additional reduction in workforce implemented in the fourth quarter of 2010, and a reduction of stock option expense as stock options forfeited exceeded the initial forfeiture rate utilized. FDIC deposit insurance premiums increased $681,000, or 21%, for 2010, compared to 2009, mainly due to an increase in the FDIC deposit assessment rate. Noninterest expense for 2010 included the $1.1 million writedown of loans held-for-sale. Insurance expense increased $368,000, or 58%, in 2010 from 2009, primarily due to an increase in the directors' and officers' insurance premiums. Foreclosed assets expense increased $132,000 for 2010, compared to 2009, primarily due to an increase in writedowns of foreclosed assets in 2010. During the second quarter of 2010, the Company determined that the entire $43.2 million of goodwill related to the acquisition of Diablo Valley Bank was impaired, due to the continued depressed economic conditions and the length of time and amount by which the Company's book value exceeded market value per share, and the Company's closing of the June 2010 private placement at a conversion price of $3.75 per share. Other operating expense decreased $576,000 in 2010 from 2009, primarily due to a lower loan provision for off-balance sheet risk liabilities and management's efforts to control costs.

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 benefit in 2011 was $834,000, as compared to an income tax benefit of $5.8 million in 2010, and an income tax benefit of $12.7 million in 2009. The following table shows the effective income tax rates for 2011, 2010, and 2009:

	For the Year Ended December 31,		
	2011	2010	2009
Effective income tax rate	-7.9%	-9.4%	-51.5%

The difference in the effective tax rate compared to the combined Federal and state statutory tax rate of 42% is primarily the result of 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, goodwill impairment, and the deferred tax asset valuation allowance.

The Company has total investments of $3.7 million in low-income housing limited partnerships as of December 31, 2011. These investments have generated annual tax credits of approximately $846,000 for the year ended December 31, 2011, and $1.0 million for the year ended December 31, 2010, and $1.1 million for the year ended December 31, 2009.

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 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.

At December 31, 2011, and December 31, 2010, the Company had net deferred tax assets of $21.9 million and $27.4 million. At December 31, 2010, the net deferred tax asset was net of a $3.7 million

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partial valuation allowance. At December 31, 2011, after consideration of the matters in the preceding paragraph, the Company determined that a valuation allowance for deferred tax assets should be $0.

Financial Condition

As of December 31, 2011, total assets were $1.31 billion, an increase of 5% compared to $1.25 billion at December 31, 2010. Total securities available-for-sale (at fair value) were $380.5 million, an increase of 64% from $232.2 million at December 31, 2010. The total loan portfolio, excluding loans held-for-sale, was $764.6 million, a decrease of 10% from $846.0 million at year-end 2010. Total deposits were $1.0 billion at December 31, 2011, an increase of 6% from $993.9 million at year-end 2010. There were no securities sold under agreement to repurchase at December 31, 2011, compared to $5.0 million at year-end 2010. In addition, there were no short-term borrowings at December 31, 2011, compared to $2.4 million at December 31, 2010.

Securities Portfolio

The following table reflects the estimated fair value for each category of securities at year-end:

Investment Portfolio

	December 31, 2011	December 31, 2010	December 31, 2009
	(Dollars in thousands)		
Securities available-for-sale (at fair value)			
U.S. Government sponsored entities	$	$	$ 1,973
Agency mortgage-backed securities	350,348	232,165	102,546
Collateralized mortgage obligations			5,447
Trust preferred securities	30,107		
Total	$ 380,455	$ 232,165	$ 109,966

The table below summarizes the weighted average life and weighted average yields of securities as of December 31, 2011. The weighted average life will differ from the contractual maturities because borrowers may have the right to call, pre-pay obligations with or without call or pre-payment penalties.

	December 31, 2011 Weighted Average Life									
	Within One Year		After One and Within Five Years		After Five and Within Ten Years		After Ten Years		Total	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
	(Dollars in thousands)									
Securities available-for-sale (at fair value):										
Mortgage-Backed Securities Residential	$		$ 225,097	2.87%	$ 91,963	2.92%	$ 33,288	3.29%	$ 350,348	2.92%
Trust preferred securities	30,107	6.39%							30,107	6.39%
	$ 30,107	6.39%	$ 225,097	2.87%	$ 91,963	2.92%	$ 33,288	3.29%	$ 380,455	3.20%

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

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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.

The Company's securities are all currently classified under existing accounting rules as "available-for-sale" to allow flexibility for the management of the portfolio. 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 Company's portfolio is historically comprised primarily of: (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.

Compared to December 31, 2010, the securities portfolio increased by $148.3 million, or 64%, and increased to 29% of total assets at December 31, 2011, from 19% at December 31, 2010. The Company increased its holding of mortgage-back securities by $118.2 million to $350.3 million at December 31, 2011, from $232.2 million at December 31, 2010 to offset a portion of the contraction in the loan portfolio. At December 31, 2011, the Company's investment portfolio included single entity issue trust preferred securities by two issuers with a carrying value of $29.9 million and market value of $30.1 million, compared to no trust preferred securities in the investment portfolio at December 31, 2010. 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 59% of total assets at December 31, 2011, as compared to 68% of at December 31, 2010. The ratio of loans to deposits decreased to 72.86% at December 31, 2011 from 85.12% December 31, 2010. Demand for loans has weakened within the Company's markets due to the current economic environment.

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

	December 31,									
	2011	% to Total	2010	% to Total	2009	% to Total	2008	% to Total	2007	% to Total
	(Dollars in thousands)									
Commercial	366,590	48%	$ 378,412	45%	$ 427,177	40%	$ 525,080	42%	$ 411,251	40%
Real estate:										
Commercial and residential	311,479	41%	337,457	40%	400,731	37%	405,530	33%	361,211	35%
Land and construction	23,016	3%	62,356	7%	182,871	17%	256,567	21%	215,597	21%
Home equity	52,017	7%	53,697	6%	51,368	5%	55,490	4%	44,187	4%
Consumer	11,166	1%	13,244	2%	7,181	1%	4,310		3,044	
Total loans	764,268	100%	845,166	100%	1,069,328	100%	1,246,977	100%	1,035,290	100%
Deferred loan costs	323		883		785		1,654		1,175	
Loans, including deferred costs	764,591	100%	846,049	100%	1,070,113	100%	1,248,631	100%	1,036,465	100%
Allowance for loan losses	(20,700)		(25,204)		(28,768)		(25,007)		(12,218)	
Loans, net	$ 743,891		$ 820,845		$ 1,041,345		$ 1,223,624		$ 1,024,247	

The Company's loan portfolio is concentrated in commercial, primarily manufacturing, wholesale, and services and commercial real estate, with a balance in land development and construction and home equity and consumer loans. The decrease in the Company's loan portfolio in 2011 is due to diminished loan demand, loan payoffs exceeding draw downs of loan commitments and payoff of classified loans. Outstanding loan balances to total loan commitments were 73% at December 31, 2011, compared to 75% at December 31, 2010. The Company does not have any concentrations by industry or group of industries in its loan portfolio, however, 51% of its gross loans were secured by real property as of December 31, 2011, compared to 54% as of December 31, 2010. 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'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 guaranteed loans (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 2011, loans were sold resulting in a gain on sale of SBA loans of $1.5 million.

As of December 31, 2011, commercial and residential real estate loans of $311.5 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, 2011 consist of $157.2 million, or 51% of commercial owner occupied properties, $151.1million, or 48%, of commercial investment properties, and $3.2 million, or 1%, of residential properties. Properties securing the commercial 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

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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. Land and construction loans decreased $39.3 million to $23.0 million, or 3% of total loans at December 31, 2011, compared to $62.3 million, or 7% of total loans at December 31, 2010.

The Company makes home equity lines of credit available to its existing customers. Home equity lines of credit are underwritten initially with a maximum 70% loan to value ratio. Home equity lines are reviewed at least semiannually, 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. There have been no adverse classifications to date as a result of the review.

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 $32.4 million and $53.9 million at December 31, 2011, respectively.

Loan Maturities

The following table presents the maturity distribution of the Company's loans as of December 31, 2011. 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, 2011, approximately 68% of the Company's loan portfolio consisted of floating interest rate loans.

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Loan Maturities

	Due in One Year or Less	Over One Year But Less than Five Years	Over Five Years	Total
	(Dollars in thousands)			
Commercial	$ 252,847	$ 36,308	$ 77,435	$ 366,590
Real estate:				
Commercial and residential	109,825	163,719	37,935	311,479
Land and construction	22,516	500		23,016
Home equity	49,965	486	1,566	52,017
Consumer	10,703	358	105	11,166
Loans	$ 445,856	$ 201,371	$ 117,041	$ 764,268
Loans with variable interest rates	$ 397,111	$ 52,588	$ 73,281	$ 522,980
Loans with fixed interest rates	48,745	148,783	43,760	241,288
Loans	$ 445,856	$ 201,371	$ 117,041	$ 764,268

Loan Servicing

As of December 31, 2011 and 2010, there were $171.0 million and $168.9 million, respectively, in SBA loans that were serviced by the Company for others. Activity for loan servicing rights was as follows:

	2011	2010	2009
	(Dollars in thousands)		
Beginning of year balance	$ 915	$ 1,067	$ 1,013
Additions	294	325	572
Amortization	(417)	(477)	(518)
End of year balance	$ 792	$ 915	$ 1,067

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, 2011 and 2010, 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:

	2011	2010	2009
	(Dollars in thousands)		
Beginning of year balance	$ 2,140	$ 2,116	$ 2,248
Additions			
Amortization	(96)	(236)	(425)
Unrealized gain	50	260	293
End of year balance	$ 2,094	$ 2,140	$ 2,116

Nonperforming Assets

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 acquired by foreclosure or similar means that management is offering or will offer for sale. Total foreclosed assets were $2.3 million at December 31, 2011, compared to $1.3 million at December 31, 2010.

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The following table provides information with respect to components of the Company's nonperforming assets at the dates indicated:

Nonperforming Assets

	December 31,				
	2011	2010	2009	2008	2007
	(Dollars in thousands)				
Nonaccrual loans held-for-sale	$ 186	$ 2,026	$	$	$
Nonaccrual loans held-for-investment	14,353	28,821	59,480	39,981	3,363
Restructured and loans 90 days past due and still accruing	2,291	2,256	2,895	460	101
Total nonperforming loans	16,830	33,103	62,375	40,441	3,464
Foreclosed assets	2,312	1,296	2,241	660	1,062
Total nonperforming assets	$ 19,142	$ 34,399	$ 64,616	$ 41,101	$ 4,526
Nonperforming assets as a percentage of loans plus nonaccrual loans held-for-sale plus foreclosed assets	2.50%	4.05%	6.03%	3.29%	0.44%
Nonperforming assets as a percentage of total assets	1.47%	2.76%	4.74%	2.74%	0.34%

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

	2011			2010		
	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	$ 8,876	$ 1,803	$ 10,679	$ 13,545	$ 593	$ 14,138
Real estate:						
Commercial and residential	2,137		2,137	6,450	1,663	8,113
Land and construction	3,514	456	3,970	9,954		9,954
Home equity		32	32			
Consumer	12		12	898		898
Total	$ 14,539	$ 2,291	$ 16,830	$ 30,847	$ 2,256	$ 33,103

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 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 losses 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 $59.5 million at December 31, 2011, $91.8 million at December 31, 2010, and $166.3 million at December 31, 2009. Included in the $59.5 million of 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. Management of the level of classified assets will continue to be a focus for executive management, the lending staff and the Company's Special Assets Department.

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 further 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

	2011	2010	2009	2008	2007
	(Dollars in thousands)				
Balance, beginning of year	$ 25,204	$ 28,768	$ 25,007	$ 12,218	$ 9,279
Charge-offs:					
Commercial	(7,559)	(7,098)	(16,512)	(2,731)	(84)
Real estate:					
Commercial and residential	(1,599)	(6,763)	(1,610)		
Land and construction	(1,757)	(17,927)	(12,588)	(75)	
Home equity		(25)	(764)		(20)
Consumer	(8)	(354)	(60)		
Total charge-offs	(10,923)	(32,167)	(31,534)	(2,806)	(104)
Recoveries:					
Commercial	678	837	1,187	49	929
Real estate:					
Commercial and residential	381	5	10		
Land and construction	879	921	170	9	
Home equity	9	36			
Consumer	3				
Total recoveries	1,950	1,799	1,367	58	929
Net (charge-offs) recoveries	(8,973)	(30,368)	(30,167)	(2,748)	825
Provision for loan losses	4,469	26,804	33,928	15,537	(11)
Allowance acquired in bank acquisition					2,125
Balance, end of year	$ 20,700	$ 25,204	$ 28,768	$ 25,007	$ 12,218
RATIOS:					
Net charge-offs (recoveries) to average loans*	1.12%	3.18%	2.59%	0.23%	-0.10%
Allowance for loan losses to total loans*	2.71%	2.98%	2.69%	2.00%	1.18%
Allowance for loan losses to nonperforming loans, excluding nonaccrual loans held-for-sale	124.37%	81.10%	46.12%	61.84%	352.71%

* Excludes loans held-for-sale

The Company's allowance for loan losses decreased $4.5 million at December 31, 2011 compared to December 31, 2010. The decrease in the allowance for loan losses at December 31, 2011 was primarily due to a lower volume of classified and nonperforming loans and lower total loans.

Net loans charged-off reflects the realization of losses in the portfolio that were partially recognized previously through provisions for loan losses. Net charge-offs were $9.0 million in 2011, compared to net charge-offs of $30.4 million in 2010, and net charge-offs of $30.2 million in 2009. Historical net loan charge-offs are not necessarily indicative of the amount of net charge-offs that the Company will realize in the future.

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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.

Allocation of Loan Loss Allowance

	December 31,									
	2011		2010		2009		2008		2007	
	Allowance	Percent of Loans in each category to total loans	Allowance	Percent of Loans in each category to total loans	Allowance	Percent of Loans in each category to total loans	Allowance	Percent of Loans in each category to total loans	Allowance	Percent of Loans in each category to total loans
	(Dollars in thousands)									
Commercial	$ 13,215	48%	$ 13,952	45%	$ 12,687	40%	$ 13,913	42%	$ 6,067	40%
Real estate:										