HERITAGE COMMERCE CORP
Form 10-Q
August 06, 2014

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(MARK ONE)

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

For the quarterly period ended June 30, 2014

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 No.)
150 Almaden Boulevard, San Jose, California	**95113**
(Address of Principal Executive Offices)	(Zip Code)

(408) 947-6900
(Registrant's Telephone Number, Including Area Code)

N/A
(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

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 whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

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

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

The Registrant had 26,370,510 shares of Common Stock outstanding on July 31, 2014.

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Cautionary Note Regarding Forward-Looking Statements

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

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

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

Delay in the pace of economic recovery and stagnant or decreasing employment levels;

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

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

Changes in consumer spending, borrowing or saving habits;

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

The ability to increase market share and control expenses;

Risks associated with concentrations in real estate related loans;

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

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

A prolonged slowdown in construction activity;

Changes in the level of nonperforming assets, charge-offs, or 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;

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

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

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- Regulatory limits on Heritage Bank of Commerce's ability to pay dividends to the Company;
- The impact of reputational risk on such matters as business generation and retention, funding and liquidity;
- The impact of cyber security attacks or other disruptions to the Company's information systems and any resulting compromise of data or disruptions in service;
- The effect of the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and the rules and regulations to be promulgated by supervisory and oversight agencies implementing the legislation taking into account that the precise timing, extent and nature of such rules and regulations and the impact on the Company are uncertain;
- The impact of revised capital requirements under Basel III;
- Significant changes in applicable laws and regulations, including those concerning taxes, banking and securities;
- Changes in the competitive environment among financial or bank holding companies and other financial service providers;
- The effect of changes in accounting policies and practices, as may be adopted by the regulatory agencies, the Public Company Accounting Oversight Board, the Financial Accounting Standards Board and other accounting standard setters;
- The costs and effects of legal and regulatory developments, including resolution of legal proceedings or regulatory or other governmental inquiries, and the results of regulatory examinations or reviews; and
- Our success in managing the risks involved in the foregoing factors.

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-Q. 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.

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Part I FINANCIAL INFORMATION

ITEM 1 CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

HERITAGE COMMERCE CORP

CONSOLIDATED BALANCE SHEETS (Unaudited)

	June 30, 2014	December 31, 2013
	(Dollars in thousands)	
Assets		
Cash and due from banks	$ 32,162	$ 20,158
Interest-bearing deposits in other financial institutions	17,256	92,447
Total cash and cash equivalents	49,418	112,605
Securities available-for-sale, at fair value	261,489	280,100
Securities held-to-maturity, at amortized cost (fair value of $92,841 at June 30, 2014 and $86,032 at December 31, 2013)	95,972	95,921
Loans held-for-sale SBA, at lower of cost or fair value, including deferred costs	2,269	3,148
Loans, net of deferred fees	990,341	914,913
Allowance for loan losses	(18,592)	(19,164)
Loans, net	971,749	895,749
Federal Home Loan Bank and Federal Reserve Bank stock, at cost	10,314	10,435
Company owned life insurance	50,452	50,012
Premises and equipment, net	7,237	7,240
Intangible assets	1,297	1,527
Accrued interest receivable and other assets	30,422	34,895
Total assets	$ 1,480,619	$ 1,491,632
Liabilities and Shareholders' Equity		
Liabilities:		
Deposits:		
Demand, noninterest-bearing	$ 456,235	$ 431,085
Demand, interest-bearing	193,041	195,451
Savings and money market	354,175	347,052
Time deposits under $100	20,379	21,646
Time deposits $100 and over	195,619	195,005
Time deposits brokered	33,614	55,524
CDARS money market and time deposits	14,785	40,458
Total deposits	1,267,848	1,286,221
Accrued interest payable and other liabilities	31,246	32,015

Total liabilities		1,299,094		1,318,236
Shareholders' equity:				
Preferred stock, no par value; 10,000,000 shares authorized				
Series C convertible perpetual preferred stock, 21,004 shares issued and outstanding at June 30, 2014 and December 31, 2013 (liquidation preference of $21,004 at June 30, 2014 and December 31, 2013)		19,519		19,519
Common stock, no par value; 60,000,000 shares authorized; 26,370,510 shares issued and outstanding at June 30, 2014 and 26,350,938 shares issued and outstanding at December 31, 2013		132,911		132,561
Retained earnings		29,187		25,345
Accumulated other comprehensive loss		(92)		(4,029)
Total shareholders' equity		181,525		173,396
Total liabilities and shareholders' equity	$	1,480,619	$	1,491,632

See notes to consolidated financial statements

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HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF INCOME (Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
	(Dollars in thousands, except per share data)			
Interest income:				
Loans, including fees	$ 11,617	$ 10,051	$ 22,756	$ 20,140
Securities, taxable	2,047	2,399	4,217	4,860
Securities, non-taxable	506	358	1,012	606
Interest-bearing deposits in other financial institutions	22	30	62	99
Total interest income	14,192	12,838	28,047	25,705
Interest expense:				
Deposits	506	595	1,027	1,220
Subordinated debt		90		178
Short-term borrowings	1		1	1
Total interest expense	507	685	1,028	1,399
Net interest income before provision for loan losses	13,685	12,153	27,019	24,306
Provision (credit) for loan losses	(198)	(270)	(208)	(270)
Net interest income after provision for loan losses	13,883	12,423	27,227	24,576
Noninterest income:				
Service charges and fees on deposit accounts	646	618	1,266	1,195
Gain on sales of SBA loans	442	134	599	270
Increase in cash surrender value of life insurance	397	410	795	826
Servicing income	313	385	661	750
Gain on sales of securities		7	50	38
Other	249	361	693	499
Total noninterest income	2,047	1,915	4,064	3,578
Noninterest expense:				
Salaries and employee benefits	6,819	5,864	13,062	11,875
Occupancy and equipment	987	1,028	1,932	2,096
Data processing	273	327	502	579
Insurance expense	269	253	538	508
FDIC deposit insurance premiums	220	207	454	466
Software subscriptions	191	294	438	585

Correspondent bank charges	183	179	365	343
Low income housing investment losses	165	300	353	611
Professional fees	126	400	712	1,382
Subordinated debt redemption charges		167		167
Foreclosed assets, net		(96)	(19)	(251)
Other	1,701	1,466	3,331	2,809
Total noninterest expense	10,934	10,389	21,668	21,170
Income before income taxes	4,996	3,949	9,623	6,984
Income tax expense	1,672	1,156	3,223	2,011
Net income	3,324	2,793	6,400	4,973
Dividends on preferred stock	(224)		(448)	
Net income available to common shareholders	$ 3,100	$ 2,793	$ 5,952	$ 4,973
Earnings per common share:				
Basic	$ 0.10	$ 0.09	$ 0.20	$ 0.16
Diluted	$ 0.10	$ 0.09	$ 0.20	$ 0.16

See notes to consolidated financial statements

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HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS) (Unaudited)

	For the Three Months Ended June 30, 2014	For the Three Months Ended June 30, 2013	For the Six Months Ended June 30, 2014	For the Six Months Ended June 30, 2013
	(Dollars in thousands)			
Net income	$ 3,324	$ 2,793	$ 6,400	$ 4,973
Other comprehensive income (loss):				
Change in net unrealized holding gains (losses) on available-for-sale securities and I/O strips	4,133	(10,544)	6,883	(12,708)
Deferred income taxes	(1,736)	4,428	(2,891)	5,337
Change in net unamortized unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity	(13)	(14)	(27)	(28)
Deferred income taxes	5	6	11	12
Reclassification adjustment for gains realized in income		(7)	(50)	(38)
Deferred income taxes		3	21	16
Change in unrealized gains (losses) on securities and I/O strips, net of deferred income taxes	2,389	(6,128)	3,947	(7,409)
Change in net pension and other benefit plan liability adjustment	(9)	36	(18)	65
Deferred income taxes	4	(15)	8	(27)
Change in pension and other benefit plan liability, net of deferred income taxes	(5)	21	(10)	38
Other comprehensive income (loss)	2,384	(6,107)	3,937	(7,371)
Total comprehensive income (loss)	$ 5,708	$ (3,314)	$ 10,337	$ (2,398)

See notes to consolidated financial statements

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HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (Unaudited)

Six Months Ended June 30, 2014 and 2013

	Preferred Stock		Common Stock		Retained	Accumulated Other Comprehensive Income /	Total Shareholders'
	Shares	Amount	Shares	Amount	Earnings	(Loss)	Equity
	(Dollars in thousands, except share data)						
Balance, January 1, 2013	21,004	$ 19,519	26,322,147	$ 131,820	$ 15,721	$ 2,681	$ 169,741
Net income					4,973		4,973
Other comprehensive loss						(7,371)	(7,371)
Issuance of restricted stock awards			10,000				
Repurchase of warrant				(140)			(140)
Amortization of restricted stock awards, net of forfeitures and taxes				116			116
Stock option expense, net of forfeitures and taxes				275			275
Stock options exercised			6,374	26			26
Balance, June 30, 2013	21,004	$ 19,519	26,338,521	$ 132,097	$ 20,694	$ (4,690)	$ 167,620
Balance, December 31, 2013	21,004	$ 19,519	26,350,938	$ 132,561	$ 25,345	$ (4,029)	$ 173,396
Net income					6,400		6,400
Other comprehensive income						3,937	3,937
Issuance of restricted stock awards, net			15,000				
Amortization of restricted stock awards, net of forfeitures and taxes				(91)			(91)
Cash dividend declared $0.08 per share					(2,558)		(2,558)
Stock option expense, net of forfeitures and taxes				422			422
Stock options exercised			4,572	19			19
Balance, June 30, 2014	21,004	$ 19,519	26,370,510	$ 132,911	$ 29,187	$ (92)	$ 181,525

See notes to consolidated financial statements

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HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

	Six Months Ended June 30, 2014	Six Months Ended June 30, 2013
	(Dollars in thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 6,400	$ 4,973
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of discounts and premiums on securities	538	1,384
Gain on sales of securities available-for-sale	(50)	(38)
Gain on sales of SBA loans	(599)	(270)
Proceeds from sale of SBA loans originated for sale	11,331	3,576
Net change in SBA loans originated for sale	(9,853)	(6,238)
Provision (credit) for loan losses	(208)	(270)
Increase in cash surrender value of life insurance	(795)	(826)
Depreciation and amortization	353	356
Amortization of intangible assets	230	237
Gains on sale of foreclosed assets, net		(231)
Stock option expense, net	422	275
Amortization of restricted stock awards, net	(91)	116
Gain on redemption of company owned life insurance	(51)	
Effect of changes in:		
Accrued interest receivable and other assets	1,564	(135)
Accrued interest payable and other liabilities	184	668
Net cash provided by operating activities	9,375	3,577
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of securities available-for-sale	(34,775)	(8,334)
Purchase of securities held-to-maturity	(2,347)	(34,681)
Maturities/paydowns/calls of securities available-for-sale	9,859	41,588
Maturities/paydowns/calls of securities held-to-maturity	1,217	2,373
Proceeds from sale of securities available-for-sale	50,011	26,944
Net change in loans	(75,792)	(29,065)
Change in Federal Home Loan Bank and Federal Reserve Bank stock	121	(143)
Purchase of premises and equipment	(350)	(428)
Proceeds from sale of foreclosed assets		809
Proceeds from redemption of company owned life insurance	406	
Net cash (used in) provided by investing activities	(51,650)	(937)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net change in deposits	(18,373)	(290,329)
Repurchase of warrant		(140)
Payment of cash dividends	(2,558)	
Exercise of stock options	19	26
Net cash used in financing activities	(20,912)	(290,443)
Net decrease in cash and cash equivalents	(63,187)	(287,803)
Cash and cash equivalents, beginning of period	112,605	373,565

Cash and cash equivalents, end of period	$	49,418	$	85,762

Supplemental disclosures of cash flow information:				
Interest paid	$	1,039	$	1,442
Income taxes paid		2,060		2,235
Supplemental schedule of non-cash investing activity:				
Due to broker for securities purchased	$		$	1,538
Loans transferred to foreclosed assets				33
Transfer of loans held-for-sale to loan portfolio				20

See notes to consolidated financial statements

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2014

(Unaudited)

1) Basis of Presentation

The unaudited consolidated financial statements of Heritage Commerce Corp (the "Company" or "HCC") and its wholly owned subsidiary, Heritage Bank of Commerce (the "Bank" or "HBC"), have been prepared pursuant to the rules and regulations for reporting on Form 10-Q. Accordingly, certain information and notes required by accounting principles generally accepted in the United States of America ("GAAP") for annual financial statements are not included herein. The interim statements should be read in conjunction with the consolidated financial statements and notes that were included in the Company's Form 10-K for the year ended December 31, 2013. The Company also established the following unconsolidated subsidiary grantor trusts: Heritage Capital Trust I; Heritage Statutory Trust I; Heritage Statutory Trust II; and Heritage Commerce Corp Statutory Trust III, which were Delaware Statutory business trusts formed for the exclusive purpose of issuing and selling trust preferred securities. During the third quarter of 2012, the Company dissolved the Heritage Statutory Trust I and the Heritage Capital Trust I. During the third quarter of 2013, the Company dissolved the Heritage Statutory Trust II and the Heritage Commerce Corp Statutory Trust III.

HBC is a commercial bank serving customers located in Santa Clara, Alameda, Contra Costa, and San Benito counties of California. No customer accounts for more than 10 percent of revenue for HBC or the Company. Management evaluates the Company's performance as a whole and does not allocate resources based on the performance of different lending or transaction activities. Accordingly, the Company and its subsidiary operate as one business segment.

In management's opinion, all adjustments necessary for a fair presentation of these consolidated financial statements have been included and are of a normal and recurring nature. All intercompany transactions and balances have been eliminated.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ significantly from these estimates.

The results for the three and six months ended June 30, 2014 are not necessarily indicative of the results expected for any subsequent period or for the entire year ending December 31, 2014.

Reclassifications

Certain reclassifications of prior year balances have been made to conform to the current year presentation. These reclassifications had no impact on the Company's consolidated financial position, results of operations or net change in cash and cash equivalents.

Adoption of New Accounting Standards

In January 2014, the Financial Accounting Standards Board ("FASB") amended existing guidance clarifying that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2014

(Unaudited)

1) Basis of Presentation (Continued)

completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The amendments in this update are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. For entities other than public business entities, the amendments in this update are effective for annual periods beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015. We are evaluating the impact of adopting the new guidance on the consolidated financial statements.

In January 2014, the FASB issued guidance for accounting for investments in qualified affordable housing projects, which represents a consensus of the Emerging Issues Task Force and sets forth new accounting for qualifying investments in flow-through limited liability entities that invest in affordable housing projects. The new guidance will allow an investor that meets certain conditions to amortize the cost of its investment in proportion to the tax credits and other tax benefits it receives. The new accounting method, referred to as the proportional amortization method, will allow amortization of the tax credit investment to be reflected along with the primary benefits, the tax credits and other tax benefits, on a net basis in the income statement within the income tax expense (benefit) line. For public business entities, the guidance is effective for interim and annual periods beginning after December 15, 2014. For all other entities, the guidance is effective for annual periods beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015. Early adoption is permitted in the annual period for which financial statements have not been issued. We are evaluating the impact of adopting the new guidance on the consolidated financial statements.

In May 2014, the FASB issued an update to the guidance for accounting for revenue from contracts with customers. The guidance in this update affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (for example, insurance contracts or lease contracts). The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance provides steps to follow to achieve the core principle. An entity should disclose sufficient information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. Qualitative and quantitative information is required about contracts with customers, significant judgments and changes in judgments, and assets recognized from the costs to obtain or fulfill a contract. The amendments in this update become effective for annual periods and interim periods within those annual periods beginning after December 15, 2016. We are evaluating the impact of adopting the new guidance on the consolidated financial statements.

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2014

(Unaudited)

2) Earnings Per Share

Basic earnings per common share is computed by dividing net income, less dividends and discount accretion on preferred stock, by the weighted average common shares outstanding. The Series C Preferred Stock participates in the earnings of the Company and, therefore, the shares issued on the conversion of the Series C Preferred Stock are considered outstanding under the two class method of computing basic earnings per common share during periods of earnings. Diluted earnings per share reflect potential dilution from outstanding stock options and common stock warrants, using the treasury stock method. The common stock warrant was antidilutive for the six months ended June 30, 2013. The Company repurchased the warrant for $140,000 in the second quarter of 2013. A reconciliation of these factors used in computing basic and diluted earnings per common share is as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2014	2013	2014	2013
	(Dollars in thousands, except per share amounts)			
Net income available to common shareholders	$ 3,100	$ 2,793	$ 5,952	$ 4,973
Less: undistributed earnings allocated to Series C Preferred Stock	358	489	673	871
Distributed and undistributed earnings allocated to common shareholders	$ 2,742	$ 2,304	$ 5,279	$ 4,102
Weighted average common shares outstanding for basic earnings per common share	26,370,510	26,336,244	26,365,167	26,332,793
Dilutive effect of stock options oustanding, using the the treasury stock method	132,891	35,648	128,299	46,123
Shares used in computing diluted earnings per common share	26,503,401	26,371,892	26,493,466	26,378,916
Basic earnings per share	$ 0.10	$ 0.09	$ 0.20	$ 0.16
Diluted earnings per share	$ 0.10	$ 0.09	$ 0.20	$ 0.16

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2014

(Unaudited)

3) Accumulated Other Comprehensive Income (Loss) ("AOCI")

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

	For the Three Months Ended June 30, 2014 and 2013			
	Unrealized Gains (Losses) on Available-for-Sale Securities and I/O Strips(1)	Unamortized Unrealized Gain on Available-for-Sale Securities Reclassified to Held-to-Maturity(1)	Defined Benefit Pension Plan Items(1)	Total(1)
	(Dollars in thousands)			
Beginning balance April 1, 2014, net of taxes	$ 1,136	$ 458	$ (4,070)	$ (2,476)
Other comprehensive income (loss) before reclassification, net of taxes	2,397		(10)	2,387
Amounts reclassified from other comprehensive income (loss), net of taxes		(8)	5	(3)
Net current period other comprensive income (loss), net of taxes	2,397	(8)	(5)	2,384
Ending balance June 30, 2014, net of taxes	$ 3,533	$ 450	$ (4,075)	$ (92)
Beginning balance April 1, 2013, net of taxes	$ 6,614	$ 489	$ (5,686)	$ 1,417
Other comprehensive (loss) before reclassification, net of taxes	(6,116)		(9)	(6,125)
Amounts reclassified from other comprehensive income (loss), net of taxes	(4)	(8)	30	18
Net current period other comprehensive income (loss), net of taxes	(6,120)	(8)	21	(6,107)
Ending balance June 30, 2013, net of taxes	$ 494	$ 481	$ (5,665)	$ (4,690)

(1) Amounts in parenthesis indicate debits.

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2014

(Unaudited)

3) Accumulated Other Comprehensive Income (Loss) ("AOCI") (Continued)

	For the Six Months Ended June 30, 2014 and 2013			
	Unrealized Gains (Losses) on Available-for-Sale Securities and I/O Strips(1)	Unamortized Unrealized Gain on Available-for-Sale Securities Reclassified to Held-to-Maturity(1)	Defined Benefit Pension Plan Items(1)	Total(1)
	(Dollars in thousands)			
Beginning balance January 1, 2014, net of taxes	$ (430)	$ 466	$ (4,065)	(4,029)
Other comprehensive (loss) before reclassification, net of taxes	3,992		(20)	3,972
Amounts reclassified from other comprehensive income (loss), net of taxes	(29)	(16)	10	(35)
Net current period other comprensive income (loss), net of taxes	3,963	(16)	(10)	3,937
Ending balance June 30, 2014, net of taxes	$ 3,533	$ 450	$ (4,075)	$ (92)
Beginning balance January 1, 2013, net of taxes	$ 7,887	$ 497	$ (5,703)	$ 2,681
Other comprehensive income (loss) before reclassification, net of taxes	(7,371)		(20)	(7,391)
Amounts reclassified from other comprehensive income (loss), net of taxes	(22)	(16)	58	20
Net current period other comprensive income, net of taxes	(7,393)	(16)	38	(7,371)
Ending balance June 30, 2013, net of taxes	$ 494	$ 481	$ (5,665)	$ (4,690)

(1) Amounts in parenthesis indicate debits.

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2014

(Unaudited)

3) Accumulated Other Comprehensive Income (Loss) ("AOCI") (Continued)

Details About AOCI Components	Amounts Reclassified from AOCI(1) For the Three Months Ended June 30, 2014	2013	Affected Line Item Where Net Income is Presented
	(Dollars in thousands)		
Unrealized gains on available-for-sale securities and I/O strips	$	$ 7	Realized gains on sale of securities
		(3)	Income tax expense
		4	Net of tax
Amortization of unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity	13	14	Interest income on taxable securities
	(5)	(6)	Income tax expense
	8	8	Net of tax
Amortization of defined benefit pension plan items(2)			
Prior transition obligation	26	23	
Actuarial losses	(35)	(75)	
	(9)	(52)	Income before income tax
	4	22	Income tax expense
	(5)	(30)	Net of tax
Total reclassification for the period	$ 3	$ (18)	

(1)

Amounts in parenthesis indicate debits.

(2) This AOCI component is included in the computation of net periodic benefit cost (see Note 7 Benefit Plans).

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2014

(Unaudited)

3) Accumulated Other Comprehensive Income (Loss) ("AOCI") (Continued)

Details About AOCI Components	Amounts Reclassified from AOCI(1) For the Six Months Ended June 30, 2014	2013	Affected Line Item Where Net Income is Presented
	(Dollars in thousands)		
Unrealized gains on available-for-sale securities and I/O strips	$ 50	$ 38	Realized gains on sale of securities
	(21)	(16)	Income tax expense
	29	22	Net of tax
Amortization of unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity	27	28	Interest income on taxable securities
	(11)	(12)	Income tax expense
	16	16	Net of tax
Amortization of defined benefit pension plan items(2)			
Prior transition obligation	52	45	
Actuarial losses	(70)	(146)	
	(18)	(101)	Income before income tax
	8	43	Income tax expense
	(10)	(58)	Net of tax
Total reclassification for the period	$ 35	$ (20)	

(1)

Amounts in parenthesis indicate debits.

(2)
This AOCI component is included in the computation of net periodic benefit cost (see Note 7 Benefit Plans).

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2014

(Unaudited)

4) Securities

The amortized cost and estimated fair value of securities at June 30, 2014 and December 31, 2013 were as follows:

June 30, 2014	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Estimated Fair Value**
		(Dollars in thousands)		
Securities available-for-sale:				
Agency mortgage-backed securities	$ 155,895	$ 3,880	$ (779)	$ 158,996
Asset-backed securities	27,349	47	(83)	27,313
Corporate bonds	52,904	1,032	(68)	53,868
Trust preferred securities	20,889	423		21,312
Total	$ 257,037	$ 5,382	$ (930)	$ 261,489
Securities held-to-maturity:				
Agency mortgage-backed securities	$ 16,037	$ 39	$ (153)	$ 15,923
Municipals tax exempt	79,935	576	(3,593)	76,918
Total	$ 95,972	$ 615	$ (3,746)	$ 92,841

December 31, 2013	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Estimated Fair Value**
		(Dollars in thousands)		
Securities available-for-sale:				
Agency mortgage-backed securities	$ 208,644	$ 2,465	$ (3,465)	$ 207,644
Corporate bonds	53,002	527	(1,483)	52,046
Trust preferred securities	20,849		(439)	20,410
Total	$ 282,495	$ 2,992	$ (5,387)	$ 280,100

Securities held-to-maturity:								
Agency mortgage-backed securities	$	15,932	$		$	(470)	$	15,462
Municipals tax exempt		79,989		54		(9,473)		70,570
Total	$	95,921	$	54	$	(9,943)	$	86,032

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2014

(Unaudited)

4) Securities (Continued)

Securities with unrealized losses at June 30, 2014 and December 31, 2013, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position are as follows:

June 30, 2014	Less Than 12 Months Fair Value	Less Than 12 Months Unrealized Losses	12 Months or More Fair Value	12 Months or More Unrealized Losses	Total Fair Value	Total Unrealized Losses
	(Dollars in thousands)					
Securities available-for-sale:						
Agency mortgage-backed securities	$ 8,387	$ (12)	$ 39,693	$ (767)	$ 48,080	$ (779)
Asset-backed securities	17,838	(83)			17,838	(83)
Corporate bonds			7,133	(68)	7,133	(68)
Trust preferred securities						
Total	$ 26,225	$ (95)	$ 46,826	$ (835)	$ 73,051	$ (930)
Securities held-to-maturity:						
Agency mortgage-backed securities	$ 1,382	$ (6)	$ 7,798	$ (147)	$ 9,180	$ (153)
Municipals Tax Exempt	2,508	(13)	58,402	(3,580)	60,910	(3,593)
Total	$ 3,890	$ (19)	$ 66,200	$ (3,727)	$ 70,090	$ (3,746)

December 31, 2013	Less Than 12 Months Fair Value	Less Than 12 Months Unrealized Losses	12 Months or More Fair Value	12 Months or More Unrealized Losses	Total Fair Value	Total Unrealized Losses
	(Dollars in thousands)					
Securities available-for-sale:						
Agency mortgage-backed securities	$ 87,798	$ (2,869)	$ 8,920	$ (596)	$ 96,718	$ (3,465)
Corporate bonds	38,092	(1,322)	1,860	(161)	39,952	(1,483)
Trust preferred securities	20,410	(439)			20,410	(439)

Total	$	146,300	$	(4,630)	$	10,780	$	(757)	$	157,080	$	(5,387)

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

There were no holdings of securities of any one issuer, other than the U.S. Government and its sponsored entities, in an amount greater than 10% of shareholders' equity. At June 30, 2014, the Company held 371 securities (141 available-for-sale and 230 held-to-maturity), of which 202 had fair values below amortized cost. At June 30, 2014, there were $39,693,000 of agency mortgage-backed securities available-for-sale, $7,133,000 of corporate bonds available-for-sale, $7,798,000 of agency mortgage-backed securities held-to-maturity and $58,402,000 of municipals bonds held-to-maturity carried with an unrealized loss for over 12 months. The total unrealized loss for securities over 12 months was $4,562,000 at June 30, 2014. The unrealized losses were due to higher interest rates.

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2014

(Unaudited)

4) Securities (Continued)

The issuers are of high credit quality and all principal amounts are expected to be paid when securities mature. The fair value is expected to recover as the securities approach their maturity date and/or market rates decline. The Company does not believe that it is more likely than not that the Company will be required to sell a security in an unrealized loss position prior to recovery in value. The Company does not consider these securities to be other than temporarily impaired at June 30, 2014.

At December 31, 2013, the Company held 392 securities (163 available-for-sale and 229 held-to-maturity), of which 275 had fair values below amortized cost. At December 31, 2013, there were $8,920,000 of agency mortgage-backed securities available-for-sale, $1,860,000 of corporate bonds available-for-sale, $9,134,000 of agency mortgage-backed securities held-to-maturity, and $25,520,000 of municipal bonds held-to-maturity carried with an unrealized loss for over 12 months. The total unrealized loss for securities over 12 months was $6,178,000 at December 31, 2013. The unrealized losses were due to higher interest rates. The issuers were of high credit quality and all principal amounts were expected to be paid when securities mature. The fair value was expected to recover as the securities approach their maturity date and/or market rates decline. The Company did not believe that it is more likely than not that the Company would be required to sell a security in an unrealized loss position prior to recovery in value. The Company did not consider these securities to be other than temporarily impaired at December 31, 2013.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
	(Dollars in thousands)			
Proceeds	$	$ 23,414	$ 50,011	$ 26,944
Gross gains		279	720	310
Gross losses		(272)	(670)	(272)

The amortized cost and estimated fair values of securities as of June 30, 2014, are shown by contractual maturity below. The expected maturities will differ from contractual maturities if borrowers have the right to call or pre-pay obligations with or without call or pre-payment penalties. Securities not due at a single maturity date are shown separately.

	Available-for-sale	
	Amortized Cost	Estimated Fair Value
	(Dollars in thousands)	
Due after one through five years	$ 6,296	$ 6,677
Due after five through ten years	46,608	47,191
Due after ten years	20,889	21,312
Asset-backed securities and agency mortgage-backed securities	183,244	186,309
Total	$ 257,037	$ 261,489

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2014

(Unaudited)

4) Securities (Continued)

	Held-to-maturity	
	Amortized Cost	Estimated Fair Value
	(Dollars in thousands)	
Due after five through ten years	$ 4,398	$ 4,462
Due after ten years	75,537	72,456
Agency mortgage-backed securities	16,037	15,923
Total	$ 95,972	$ 92,841

5) Loans

Loans were as follows:

	June 30, 2014	December 31, 2013
	(Dollars in thousands)	
Loans held-for-investment:		
Commercial	$ 415,557	$ 393,074
Real estate:		
Commercial and residential	454,676	423,288
Land and construction	47,758	31,443
Home equity	56,743	51,815
Consumer	16,112	15,677
Loans	990,846	915,297
Deferred loan origination fees, net	(505)	(384)
Loans, net of deferred fees	990,341	914,913
Allowance for loan losses	(18,592)	(19,164)
Loans, net	$ 971,749	$ 895,749

Changes in the allowance for loan losses were as follows for the periods indicated:

	Three Months Ended June 30, 2014			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	$ 11,846	$ 6,894	$ 77	$ 18,817
Charge-offs	(187)			(187)
Recoveries	144	16		160
Net (charge-offs) recoveries	(43)	16		(27)
Provision (credit) for loan losses	(349)	159	(8)	(198)
Balance, end of period	$ 11,454	$ 7,069	$ 69	$ 18,592

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2014

(Unaudited)

5) Loans (Continued)

	Three Months Ended June 30, 2013			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	$ 12,455	$ 6,770	$ 117	$ 19,342
Charge-offs	(119)	(56)		(175)
Recoveries	188	257		445
Net recoveries	69	201		270
Provision (credit) for loan losses	287	(583)	26	(270)
Balance, end of period	$ 12,811	$ 6,388	$ 143	$ 19,342

	Six Months Ended June 30, 2014			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	$ 12,533	$ 6,548	$ 83	$ 19,164
Charge-offs	(595)			(595)
Recoveries	188	43		231
Net (charge-offs) recoveries	(407)	43		(364)
Provision (credit) for loan losses	(672)	478	(14)	(208)
Balance, end of period	$ 11,454	$ 7,069	$ 69	$ 18,592

	Six Months Ended June 30, 2013			
	Commercial	Real Estate	Consumer	Total

	(Dollars in thousands)			
Balance, beginning of period	$ 12,866	$ 6,034	$ 127	$ 19,027
Charge-offs	(959)	(56)		(1,015)
Recoveries	1,338	262		1,600
Net recoveries	379	206		585
Provision (credit) for loan losses	(434)	148	16	(270)
Balance, end of period	$ 12,811	$ 6,388	$ 143	$ 19,342

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2014

(Unaudited)

5) Loans (Continued)

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

	June 30, 2014			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Allowance for loan losses:				
Ending allowance balance attributable to loans:				
Individually evaluated for impairment	$ 1,196	$ 313	$ 3	$ 1,512
Collectively evaluated for impairment	10,258	6,756	66	17,080
Total allowance balance	$ 11,454	$ 7,069	$ 69	$ 18,592
Loans:				
Individually evaluated for impairment	$ 4,183	$ 5,107	$ 32	$ 9,322
Collectively evaluated for impairment	411,374	554,070	16,080	981,524
Total loan balance	$ 415,557	$ 559,177	$ 16,112	$ 990,846

	December 31, 2013			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Allowance for loan losses:				
Ending allowance balance attributable to loans:				
Individually evaluated for impairment	$ 1,694	$ 741	$ 21	$ 2,456
Collectively evaluated for impairment	10,839	5,807	62	16,708
Total allowance balance	$ 12,533	$ 6,548	$ 83	$ 19,164

Loans:								
Individually evaluated for impairment	$	4,906	$	6,790	$	122	$	11,818
Collectively evaluated for impairment		388,168		499,756		15,555		903,479
Total loan balance	$	393,074	$	506,546	$	15,677	$	915,297

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2014

(Unaudited)

5) Loans (Continued)

The following table presents loans held-for-investment individually evaluated for impairment by class of loans as of June 30, 2014 and December 31, 2013. The recorded investment included in the following table represents loan principal net of any partial charge-offs recognized on the loans. The unpaid principal balance represents the recorded balance prior to any partial charge-offs.

	June 30, 2014			December 31, 2013		
	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated
	(Dollars in thousands)					
With no related allowance recorded:						
Commercial	$ 2,522	$ 2,123	$	$ 1,999	$ 1,915	$
Real estate:						
Commercial and residential	2,552	1,693		2,831	2,831	
Land and construction	2,177	1,688		1,761	1,761	
Home Equity	367	367		377	377	
Total with no related allowance recorded	7,618	5,871		6,968	6,884	
With an allowance recorded:						
Commercial	2,384	2,060	1,196	3,225	2,991	1,694
Real estate:						
Commercial and residential	1,180	1,180	134	1,531	1,531	451
Home Equity	179	179	179	290	290	290
Consumer	32	32	3	122	122	21
Total with an allowance recorded	3,775	3,451	1,512	5,168	4,934	2,456
Total	$ 11,393	$ 9,322	$ 1,512	$ 12,136	$ 11,818	$ 2,456

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

	Three Months Ended June 30, 2014					
		Real Estate				
	Commercial	Commercial and Residential	Land and Construction	Home Equity	Consumer	Total

	(Dollars in thousands)											
Average of impaired loans during the period	$	4,670	$	3,051	$	1,703	$	576	$	73	$	10,073
Interest income during impairment	$	56	$		$		$		$		$	56
Cash-basis interest earned	$		$		$		$		$		$	

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2014

(Unaudited)

5) Loans (Continued)

	Three Months Ended June 30, 2013					
		Real Estate				
	Commercial	Commercial and Residential	Land and Construction	Home Equity	Consumer	Total
	(Dollars in thousands)					
Average of impaired loans during the period	$ 6,736	$ 5,286	$ 2,153	$ 2,401	$ 138	$ 16,714
Interest income during impairment	$	$	$	$	$	$
Cash-basis interest earned	$	$	$	$	$	$

	Six Months Ended June 30, 2014					
		Real Estate				
	Commercial	Commercial and Residential	Land and Construction	Home Equity	Consumer	Total
	(Dollars in thousands)					
Average of impaired loans during the period	$ 4,749	$ 3,488	$ 1,722	$ 606	$ 90	$ 10,655
Interest income during impairment	$ 56	$	$	$	$	$ 56
Cash-basis interest earned	$	$	$	$	$	$

	Six Months Ended June 30, 2013					
		Real Estate				
	Commercial	Commercial and Residential	Land and Construction	Home Equity	Consumer	Total
	(Dollars in thousands)					
Average of impaired loans during the period	$ 7,877	$ 5,083	$ 2,177	$ 2,413	$ 141	$ 17,691
Interest income during impairment	$	$	$	$	$	$
Cash-basis interest earned	$	$	$	$	$	$

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

	June 30,		December 31,
	2014	2013	2013

	(Dollars in thousands)		
Nonaccrual loans held-for-investment	$ 7,688	$ 13,868	$ 11,326
Restructured and loans over 90 days past due and still accruing	454	510	492
Total nonperforming loans	$ 8,142	$ 14,378	$ 11,818
Other restructured loans	$ 1,180	$ 668	$
Impaired loans, excluding loans held-for-sale	$ 9,322	$ 15,046	$ 11,818

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2014

(Unaudited)

5) Loans (Continued)

The following table presents the nonperforming loans by class for the periods indicated:

	June 30, 2014			December 31, 2013		
	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	$ 3,729	$ 454	$ 4,183	$ 4,414	$ 492	$ 4,906
Real estate:						
Commercial and residential	1,693		1,693	4,363		4,363
Land and construction	1,688		1,688	1,761		1,761
Home equity	546		546	666		666
Consumer	32		32	122		122
Total	$ 7,688	$ 454	$ 8,142	$ 11,326	$ 492	$ 11,818

The following tables present the aging of past due loans by class for the periods indicated:

	June 30, 2014					
	30 - 59 Days Past Due	60 - 89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Loans Not Past Due	Total
	(Dollars in thousands)					
Commercial	$ 410	$ 1,210	$ 1,517	$ 3,137	$ 412,420	$ 415,557
Real estate:						
Commercial and residential	4,308		1,065	5,373	449,303	454,676
Land and construction	314			314	47,444	47,758
Home equity	367		178	545	56,198	56,743
Consumer			25	25	16,087	16,112
Total	$ 5,399	$ 1,210	$ 2,785	$ 9,394	$ 981,452	$ 990,846

	December 31, 2013					
	30 - 59 Days Past Due	60 - 89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Loans Not Past Due	Total
	(Dollars in thousands)					
Commercial	$ 3,314	$ 428	$ 2,865	$ 6,607	$ 386,467	$ 393,074
Real estate:						
Commercial and residential	1,559		1,065	2,624	420,664	423,288
Land and construction					31,443	31,443
Home equity	28		290	318	51,497	51,815
Consumer			89	89	15,588	15,677
Total	$ 4,901	$ 428	$ 4,309	$ 9,638	$ 905,659	$ 915,297

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2014

(Unaudited)

5) Loans (Continued)

Past due loans 30 days or greater totaled $9,394,000 and $9,638,000 at June 30, 2014 and December 31, 2013, respectively, of which $4,657,000 and $5,900,000 were on nonaccrual. At June 30, 2014, there were also $3,031,000 loans less than 30 days past due included in nonaccrual loans held-for-investment. At December 31, 2013, there were also $5,426,000 loans less than 30 days past due included in nonaccrual loans held- for-investment. Management's classification of a loan as "nonaccrual" is an indication that there is reasonable doubt as to the full recovery of principal or interest on the loan. At that point, the Company stops accruing interest income, and reverses any uncollected interest that had been accrued as income. The Company begins recognizing interest income only as cash interest payments are received and it has been determined the collection of all outstanding principal is not in doubt. The loans may or may not be collateralized, and collection efforts are pursued.

Credit Quality Indicators

Concentrations of credit risk arise when a number of customers are engaged in similar business activities, or activities in the same geographic region, or have similar features that would cause their ability to meet contractual obligations to be similarly affected by changes in economic conditions. The Company's loan portfolio is concentrated in commercial (primarily manufacturing, wholesale, and service) and real estate lending, with the balance in consumer loans. While no specific industry concentration is considered significant, the Company's lending operations are located in the Company's market areas that are dependent on the technology and real estate industries and their supporting companies. Thus, the Company's borrowers could be adversely impacted by a downturn in these sectors of the economy which could reduce the demand for loans and adversely impact the borrowers' ability to repay their loans.

The Company categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The Company analyzes loans individually by classifying the loans as to credit risk. This analysis is performed on a quarterly basis. Nonclassified loans generally include those loans that are expected to be repaid in accordance with contractual loans terms. Classified loans are those loans that are assigned a substandard, substandard-nonaccrual, or doubtful risk rating using the following definitions:

Substandard. Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

Substandard-Nonaccrual. Loans classified as substandard-nonaccrual are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any, and it is probable that the Company will not receive payment of the full contractual principal and interest. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected. In addition, the Company no longer accrues interest on the loan because of the underlying weaknesses.

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2014

(Unaudited)

5) Loans (Continued)

Doubtful. Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

Loss. Loans classified as loss are considered uncollectable or of so little value that their continuance as assets is not warranted. This classification does not necessarily mean that a loan has no recovery or salvage value; but rather, there is much doubt about whether, how much, or when the recovery would occur. Loans classified as loss are immediately charged off against the allowance for loan losses. Therefore, there is no balance to report at June 30, 2014 or December 31, 2013.

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

	June 30, 2014			December 31, 2013		
	Nonclassified	Classified*	Total	Nonclassified	Classified*	Total
	(Dollars in thousands)					
Commercial	$ 405,575	$ 9,982	$ 415,557	$ 380,806	$ 12,268	$ 393,074
Real estate:						
Commercial and residential	446,287	8,389	454,676	416,992	6,296	423,288
Land and construction	46,070	1,688	47,758	29,682	1,761	31,443
Home equity	53,885	2,858	56,743	48,818	2,997	51,815
Consumer	15,872	240	16,112	15,336	341	15,677
Total	$ 967,689	$ 23,157	$ 990,846	$ 891,634	$ 23,663	$ 915,297

* Classified loans in the table above include Small Business Administration ("SBA") guarantees.

In order to determine whether a borrower is experiencing financial difficulty, an evaluation is performed of the probability that the borrower will be in payment default on any of its debt in the foreseeable future without the modification. This evaluation is performed in accordance with the Company's underwriting policy.

The recorded investment of troubled debt restructurings at June 30, 2014 was $3,124,000, which included $1,490,000 of nonaccrual loans and $1,634,000 of accruing loans. The book balance of troubled debt restructurings at December 31, 2013 was $3,722,000, which included $3,230,000 of nonaccrual loans and $492,000 of accruing loans. Approximately $757,000 and $1,186,000 in specific reserves were established with respect to these loans as of June 30, 2014 and December 31, 2013, respectively. As of June 30, 2014 and December 31, 2013, the Company had no additional amounts committed on any loan classified as a troubled debt restructuring.

There were no new loans modified as troubled debt restructurings during the three and six month periods ended June 30, 2014 and 2013.

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2014

(Unaudited)

5) Loans (Continued)

A loan is considered to be in payment default when it is 30 days contractually past due under the modified terms. There were no defaults on troubled debt restructurings, within twelve months following the modification, during the three and six month periods ended June 30, 2014 and 2013.

A loan that is a troubled debt restructuring on nonaccrual status may return to accruing status after a period of at least six months of consecutive payments in accordance with the modified terms.

6) Income Taxes

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.

The Company had net deferred tax assets of $19,105,000, and $23,326,000, at June 30, 2014, and December 31, 2013, respectively. After consideration of the matters in the preceding paragraph, the Company determined that it is more likely than not that the net deferred tax asset at June 30, 2014 and December 31, 2013 will be fully realized in future years.

7) Benefit Plans

Supplemental Retirement Plan

The Company has a supplemental retirement plan (the "Plan") covering current and former key executives and directors. The Plan is a nonqualified defined benefit plan. Benefits are unsecured as

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2014

(Unaudited)

7) Benefit Plans (Continued)

there are no Plan assets. The following table presents the amount of periodic cost recognized for the periods indicated:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	**2013**	**2014**	**2013**
	(Dollars in thousands)		(Dollars in thousands)	
Components of net periodic benefit cost:				
Service cost	$ 179	$ 302	$ 358	$ 606
Interest cost	228	196	456	392
Amortization of net actuarial loss	35	75	70	146
Net periodic benefit cost	$ 442	$ 573	$ 884	$ 1,144

Split-Dollar Life Insurance Benefit Plan

The Company maintains life insurance policies for current and former directors and officers that are subject to split-dollar life insurance agreements. The following table sets forth the funded status of the split-dollar life insurance benefits for the periods indicated:

	June 30, 2014	December 31, 2013
	(Dollars in thousands)	
Change in projected benefit obligation		
Projected benefit obligation at beginning of year	$ 4,353	$ 4,717
Interest cost	98	177
Actuarial gain		(541)
Projected benefit obligation at end of period	$ 4,451	$ 4,353

	June 30, 2014	December 31, 2013
	(Dollars in thousands)	
Net actuarial loss	$ 352	$ 256
Prior transition obligation	1,552	1,597

Accumulated other comprehensive loss	$ 1,904	$ 1,853

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2014	2013	2014	2013
	(Dollars in thousands)		(Dollars in thousands)	
Amortization of prior transition obligation	$ (26)	$ (23)	$ (52)	$ (45)
Interest cost	49	44	98	88
Net periodic benefit cost	$ 23	$ 21	$ 46	$ 43

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2014

(Unaudited)

8) Equity

Common Stock Warrant

The common stock warrant issued to the U.S. Treasury as part of the Company's participation in the U.S. Treasury Capital Purchase Program was repurchased by the Company in the second quarter of 2013.

Series C Preferred Stock

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

9) Fair Value

Accounting guidance establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities in active markets; quoted prices for identical assets or liabilities in markets that are not active; or other inputs that are observable or can be corroborated by observable market data (for example, interest rates and yield curves observable at commonly quoted intervals, prepayment speeds, credit risks, and default rates).

Level 3: Significant unobservable inputs that reflect a reporting entity's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

Financial Assets and Liabilities Measured on a Recurring Basis

The fair values of securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges (Level 1 inputs) or matrix pricing, which is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities, but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2 inputs).

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2014

(Unaudited)

9) Fair Value (Continued)

The fair value of interest-only ("I/O") strip receivable assets is based on a valuation model used by a third party. The Company is able to compare the valuation model inputs and results to widely available published industry data for reasonableness (Level 2 inputs).

		Fair Value Measurements Using		
	Balance	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	(Dollars in thousands)			
Assets at June 30, 2014:				
Available-for-sale securities:				
Agency mortgage-backed securities	$ 158,996		$ 158,996	
Asset-backed securities	$ 27,313		$ 27,313	
Corporate bonds	$ 53,868		$ 53,868	
Trust preferred securities	$ 21,312		$ 21,312	
I/O strip receivables	$ 1,633		$ 1,633	
Assets at December 31, 2013:				
Available-for-sale securities:				
Agency mortgage-backed securities	$ 207,644		$ 207,644	
Corporate bonds	$ 52,046		$ 52,046	
Trust preferred securities	$ 20,410		$ 20,410	
I/O strip receivables	$ 1,647		$ 1,647	

There were no transfers between Level 1 and Level 2 during the period for assets measured at fair value on a recurring basis.

Assets and Liabilities Measured on a Non-Recurring Basis

The fair value of impaired loans with specific allocations of the allowance for loan losses is generally based on recent real estate appraisals. The appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

Foreclosed assets are valued at the time the loan is foreclosed upon and the asset is transferred to foreclosed assets. The fair value is based primarily on third party appraisals, less costs to sell. The appraisals may utilize a single valuation approach or a combination of approaches including the comparable sales and income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2014

(Unaudited)

9) Fair Value (Continued)

adjustments are typically significant and result in a Level 3 classification of the inputs for determining fair value.

		Fair Value Measurements Using		
	Balance	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
		(Dollars in thousands)		
Assets at June 30, 2014:				
Impaired loans held-for-investment:				
Commercial	$ 1,445			$ 1,445
Real estate:				
Commercial and residential	1,675			1,675
Land and construction	1,232			1,232
Consumer	28			28
	$ 4,380			$ 4,380
Assets at December 31, 2013:				
Impaired loans held-for-investment:				
Commercial	$ 1,780			$ 1,780
Real estate:				
Commercial and residential	2,846			2,846
Land and construction	1,290			1,290
Consumer	100			100
	$ 6,016			$ 6,016
Foreclosed assets:				
Land and construction	$ 575			$ 575
	$ 575			$ 575

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2014

(Unaudited)

9) Fair Value (Continued)

The following table shows the detail of the impaired loans held-for- investment and the impaired loans held-for-investment carried at fair value for the periods indicated:

	June 30, 2014	December 31, 2013
	(Dollars in thousands)	
Impaired loans held-for-investment:		
Book value of impaired loans held-for-investment carried at fair value	$ 5,892	$ 8,472
Book value of impaired loans held-for-investment carried at cost	3,430	3,346
Total impaired loans held-for-investment	$ 9,322	$ 11,818
Impaired loans held-for-investment carried at fair value:		
Book value of impaired loans held-for-investment carried at fair value	$ 5,892	$ 8,472
Specific valuation allowance	(1,512)	(2,456)
Impaired loans held-for-investment carried at fair value, net	$ 4,380	$ 6,016

Impaired loans held-for-investment which are measured primarily for impairment using the fair value of the collateral were $9,322,000 at June 30, 2014, after partial charge-offs of $264,000 in the first six months of 2014. In addition, these loans had a specific valuation allowance of $1,512,000 at June 30, 2014. Impaired loans held-for-investment totaling $5,892,000 at June 30, 2014 were carried at fair value as a result of the aforementioned partial charge-offs and specific valuation allowances at period-end. The remaining $3,430,000 of impaired loans were carried at cost at June 30, 2014, as the fair value of the collateral exceeded the cost basis of each respective loan. Partial charge-offs and changes in specific valuation allowances during the first six months of 2014 on impaired loans held-for-investment carried at fair value at June 30, 2014 resulted in an additional provision for loan losses of $421,000.

Impaired loans held for investment of $11,818,000 at December 31, 2013, after partial charge offs of $318,000 in 2013, were analyzed for additional impairment primarily using the fair value of collateral. In addition, these loans had a specific valuation allowance of $2,456,000 at December 31, 2013. Impaired loans held for investment totaling $8,472,000 at December 31, 2013 were carried at fair value as a result of the aforementioned partial charge offs and specific valuation allowances at year end. The remaining $3,346,000 of impaired loans were carried at cost at December 31, 2013, as the fair value of the collateral exceeded the cost basis of each respective loan. Partial charge offs and changes in specific valuation allowances during 2013 on impaired loans held for investment carried at fair value at December 31, 2013 resulted in an additional provision for loan losses of $508,000.

At December 31, 2013, foreclosed assets had a carrying amount of $575,000, with no valuation allowance at December 31, 2013.

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2014

(Unaudited)

9) Fair Value (Continued)

The following table presents quantitative information about level 3 fair value measurements for financial instruments measured at fair value on a non-recurring basis at the periods indicated:

	June 30, 2014			
	Fair Value	**Valuation Techniques**	**Unobservable Inputs**	**Range (Weighted Average)**
	(Dollars in thousands)			
Impaired loans held-for-investment:				
Commercial	$ 1,445	Market Approach	Discount adjustment for differences between comparable sales	0% to 3% (3%)
Real estate:				
Commercial and residential	$ 1,675	Market Approach	Discount adjustment for differences between comparable sales	2% to 3% (2%)
Land and construction	$ 1,232	Market Approach	Discount adjustment for differences between comparable sales	1% to 2% (2%)

	December 31, 2013			
	Fair Value	**Valuation Techniques**	**Unobservable Inputs**	**Range (Weighted Average)**
	(Dollars in thousands)			
Impaired loans held-for-investment:				
Commercial	$ 1,780	Market Approach	Discount adjustment for differences between comparable sales	2% to 3% (2%)
Real estate:				
Commercial and residential	$ 2,846	Market Approach	Discount adjustment for differences between comparable sales	1% to 15% (2%)
Land and construction	$ 1,290			

			Market Approach	Discount adjustment for differences between comparable sales	1% to 2% (2%)
Foreclosed assets:					
Land and construction	$	575	Market Approach	Discount adjustment for differences between comparable sales	1% to 16% (7%)

The Company obtains third party appraisals on its impaired loans held- for-investment and foreclosed assets to determine fair value. Generally, the third party appraisals apply the "market approach," which is a valuation technique that uses prices and other relevant information generated by market transactions involving identical or comparable (that is, similar) assets, liabilities, or a group of assets and liabilities, such as a business. Adjustments are then made based on the type of property, age

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2014

(Unaudited)

9) Fair Value (Continued)

of appraisal, current status of property and other related factors to estimate the current value of collateral.

The carrying amounts and estimated fair values of financial instruments at June 30, 2014 are as follows:

		Estimated Fair Value			
	Carrying Amounts	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
	(Dollars in thousands)				
Assets:					
Cash and cash equivalents	$ 49,418	$ 49,418			$ 49,418
Securities available-for-sale	$ 261,489		$ 261,489		$ 261,489
Securities held-to-maturity	$ 95,972		$ 92,841		$ 92,841
Loans (including loans held-for-sale), net	$ 974,018		$ 2,269	$ 965,646	$ 967,915
FHLB and FRB stock	$ 10,314				N/A
Accrued interest receivable	$ 4,218		$ 1,605	$ 2,613	$ 4,218
Loan servicing rights and I/O strips receivables	$ 2,239		$ 4,280		$ 4,280
Liabilities:					
Time deposits	$ 257,547		$ 257,984		$ 257,984
Other deposits	$ 1,010,301		$ 1,010,301		$ 1,010,301
Accrued interest payable	$ 181		$ 181		$ 181

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2014

(Unaudited)

9) Fair Value (Continued)

The carrying amounts and estimated fair values of the Company's financial instruments at December 31, 2013:

	Carrying Amounts	Estimated Fair Value Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
		(Dollars in thousands)			
Assets:					
Cash and cash equivalents	$ 112,605	$ 112,605			$ 112,605
Securities available-for-sale	$ 280,100		$ 280,100		$ 280,100
Securities held-to-maturity	$ 95,921		$ 86,032		$ 86,032
Loans (including loans held-for-sale), net	$ 898,897		$ 3,148	$ 890,368	$ 893,516
FHLB and FRB stock	$ 10,435				N/A
Accrued interest receivable	$ 4,085		$ 1,729	$ 2,356	$ 4,085
Loan servicing rights and I/O strips receivables	$ 2,172		$ 4,203		$ 4,203
Liabilities:					
Time deposits	$ 277,844		$ 278,239		$ 278,239
Other deposits	$ 1,008,377		$ 1,008,377		$ 1,008,377
Accrued interest payable	$ 192		$ 192		$ 192

The methods and assumptions, not previously discussed, used to estimate the fair value are described as follows:

Cash and Cash Equivalents

The carrying amounts of cash on hand, noninterest and interest bearing due from bank accounts, and Fed funds sold approximate fair values and are classified as Level 1.

Loans

The fair value of loans held-for-sale is estimated based upon binding contracts and quotes from third parties resulting in a Level 2 classification.

Fair values of loans, excluding loans held for sale, are estimated as follows: For variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values resulting in a Level 3 classification. Fair values for other loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality resulting in a Level 3 classification. Impaired loans are valued at the lower of cost or fair value as described previously. The methods utilized to estimate the fair value of loans do not necessarily represent an exit price.

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2014

(Unaudited)

9) Fair Value (Continued)

FHLB and FRB Stock

It was not practical to determine the fair value of FHLB and FRB stock due to restrictions placed on their transferability.

Accrued Interest Receivable/Payable

The carrying amounts of accrued interest approximate fair value resulting in a Level 2 or Level 3 classification.

Deposits

The fair values disclosed for demand deposits (e.g., interest and noninterest checking, passbook savings, and certain types of money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amount) resulting in a Level 2 classification. The carrying amounts of variable rate, fixed-term money market accounts approximate their fair values at the reporting date resulting in a Level 2 classification. The carrying amounts of variable rate, certificates of deposit approximate their fair values at the reporting date resulting in a Level 2 classification. Fair values for fixed rate certificates of deposit are estimated using a discounted cash flows calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits resulting in a Level 2 classification.

Off-balance Sheet Instruments

Fair values for off-balance sheet, credit-related financial instruments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing. The fair value of commitments is not material.

Limitations

Fair value estimates are made at a specific point in time, based on relevant market information about the financial instruments. These estimates do not reflect any premium or discount that could result from offering for sale at one time the entire holdings of a particular financial instrument. Fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

10) Equity Plan

The Company maintained an Amended and Restated 2004 Equity Plan (the "2004 Plan") for directors, officers, and key employees. The 2004 Plan was terminated on May 23, 2013. On May 23, 2013, the Company's shareholders approved the 2013 Equity Incentive Plan (the "2013 Plan"). The equity plans provide for the grant of incentive and nonqualified stock options and restricted stock. The equity plans provide that the option price for both incentive and nonqualified stock options will be

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2014

(Unaudited)

10) Equity Plan (Continued)

determined by the Board of Directors at no less than the fair value at the date of grant. Options granted vest on a schedule determined by the Board of Directors at the time of grant. Generally options vest over four years. All options expire no later than ten years from the date of grant. Restricted stock is subject to time vesting. As of June 30, 2014, the Company granted 312,050 shares of nonqualified stock options and 15,000 shares of restricted stock subject to time vesting requirements. There were 1,400,450 shares available for the issuance of equity awards under the 2013 Plan as of June 30, 2014.

Stock option activity under the equity plans is as follows:

Total Stock Options	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value
Outstanding at January 1, 2014	1,506,504	$ 11.80		
Granted	312,050	$ 8.07		
Exercised	(4,572)	$ 4.20		
Forfeited or expired	(40,786)	$ 13.28		
Outstanding at June 30, 2014	1,773,196	$ 11.13	6.2	$ 1,984,000
Vested or expected to vest	1,684,536		6.2	$ 1,884,800
Exercisable at June 30, 2014	1,142,160		4.6	$ 1,362,000

As of June 30, 2014, there was $2,376,000 of total unrecognized compensation cost related to nonvested stock options granted under the equity plans. That cost is expected to be recognized over a weighted-average period of approximately 2.96 years.

Restricted stock activity under the equity plans is as follows:

Total Restricted Stock Award	Number of Shares	Weighted Average Grant Date Fair Value
Nonvested shares at January 1, 2014	58,000	$ 6.28
Granted	15,000	$ 8.23

Exercised	(18,000)	$	6.39
Nonvested shares at June 30, 2014	55,000	$	6.77

As of June 30, 2014, there was $138,000 of total unrecognized compensation cost related to nonvested restricted stock awards granted under the equity plans. The cost is expected to be recognized over a weighted-average period of approximately 2.89 years.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2014

(Unaudited)

11) Capital Requirements

The Company and its subsidiary bank are subject to various regulatory capital requirements administered by the banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's financial statements and operations. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and HBC must meet specific capital guidelines that involve quantitative measures of assets, liabilities, and certain off balance sheet items as calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to help ensure capital adequacy require the Company and HBC to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital (as defined in the regulations) to risk weighted assets (as defined), and of Tier 1 capital to average assets (as defined). Management believes that, as of June 30, 2014 and 2013, the Company and HBC met all capital adequacy guidelines to which they were subject.

The Company's consolidated capital amounts and ratios are presented in the following table, together with capital adequacy requirements.

	Actual		To Be Well-Capitalized Under Regulatory Requirements		Required For Capital Adequacy Purposes	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
			(Dollars in thousands)			
As of June 30, 2014:						
Total Capital (to risk-weighted assets)	$ 191,950	15.1%	$ 126,822	10.0%	$ 101,457	8.0%
Tier 1 Capital (to risk-weighted assets)	$ 176,057	13.9%	$ 76,093	6.0%	$ 50,729	4.0%
Tier 1 Capital (to average assets)	$ 176,057	12.0%	N/A	N/A	$ 58,450	4.0%
As of December 31, 2013:						
Total Capital (to risk-weighted assets)	$ 179,916	15.3%	$ 117,581	10.0%	$ 94,065	8.0%
Tier 1 Capital (to risk-weighted assets)	$ 165,612	14.0%	$ 70,549	6.0%	$ 47,032	4.0%
Tier 1 Capital (to average assets)	$ 165,612	11.2%	N/A	N/A	$ 59,083	4.0%

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2014

(Unaudited)

11) Capital Requirements (Continued)

HBC's actual capital and required amounts and ratios are presented in the following table.

	Actual		To Be Well-Capitalized Under Prompt Corrective Action Provisions		Required For Capital Adequacy Purposes	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
	(Dollars in thousands)					
As of June 30, 2014:						
Total Capital (to risk-weighted assets)	$ 179,379	14.1%	$ 127,133	10.0%	$ 101,706	8.0%
Tier 1 Capital (to risk-weighted assets)	$ 163,448	12.9%	$ 76,280	6.0%	$ 50,853	4.0%
Tier 1 Capital (to average assets)	$ 163,448	11.2%	$ 73,215	5.0%	$ 58,572	4.0%
As of December 31, 2013:						
Total Capital (to risk-weighted assets)	$ 163,827	13.9%	$ 117,872	10.0%	$ 94,297	8.0%
Tier 1 Capital (to risk-weighted assets)	$ 149,037	12.6%	$ 70,723	6.0%	$ 47,148	4.0%
Tier 1 Capital (to average assets)	$ 149,037	10.1%	$ 73,858	5.0%	$ 59,086	4.0%

As of June 30, 2014 the Company's and HBC's capital ratios exceed the highest regulatory capital requirement of prompt corrective provisions. There are no conditions or events since June 30, 2014 that management believes have changed the categorization of the Company or HBC as well capitalized.

HCC is dependent upon dividends from HBC. Under California General Corporation Law, the holders of common stock are entitled to receive dividends when and as declared by the Board of Directors, out of funds legally available. The California Financial Code provides that a state licensed bank may not make a cash distribution to its shareholders in excess of the lesser of the following: (i) the bank's retained earnings; or (ii) the bank's net income for its last three fiscal years, less the amount of any distributions made by the bank to its shareholders during such period. However, a bank, with the prior approval of the Commissioner of the California Department of Business Oversight Division of Financial Institutions may make a distribution to its shareholders of an amount not to exceed the greater of (i) a bank's retained earnings; (ii) its net income for its last fiscal year; or (iii) its net income for the current fiscal year. Also with the prior approval of the Commissioner of the California Department of Business Oversight ("DBO") and the shareholders of the bank, the bank may make a distribution to its shareholders, as a reduction in capital of the bank. In the event that the Commissioner determines that the shareholders' equity of a bank is inadequate or that the making of a distribution by a bank would be unsafe or unsound, the Commissioner may order a bank to refrain from making such a proposed distribution. As of June 30, 2014, HBC would be required to obtain regulatory approval from the DBO for a dividend or other distribution to HCC. Similar restrictions

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2014

(Unaudited)

11) Capital Requirements (Continued)

applied to the amount and sum of loan advances and other transfers of funds from HBC to the parent company.

12) Loss Contingencies

The Company's policy is to accrue for legal costs associated with both asserted and unasserted claims when it is probable that such costs will be incurred and such costs can be reasonably estimated. A number of parties have filed complaints in the Superior Court of California for the County of Santa Clara asserting certain claims against the Company arising from the transfer of funds. The litigation is in the early stages and it is not possible to determine the amount of the loss, if any, arising from the claim in excess of the legal expenses expected to be incurred in defense of the litigation. The Company intends to vigorously defend the litigation.

13) Subsequent Event

On July 24, 2014, the Company announced that its Board of Directors declared a $0.05 per share quarterly cash dividend to holders of common stock and Series C preferred stock (on an as converted basis). The dividend will be paid on August 27, 2014, to shareholders of record on August 7, 2014.

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ITEM 2 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 Heritage Commerce Corp (the "Company" or "HCC") and its wholly owned subsidiary, Heritage Bank of Commerce (sometimes referred to as the "Bank" or "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. Unless we state otherwise or the context indicates otherwise, references to the "Company," "Heritage," "we," "us," and "our," in this Report on Form 10-Q refer to Heritage Commerce Corp and Heritage Bank of Commerce.

CRITICAL ACCOUNTING POLICIES

Critical accounting policies are discussed in our Form 10-K for the year ended December 31, 2013. There are no changes to these policies as of June 30, 2014.

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 Contra Costa, and San Benito. 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 three months ended June 30, 2014, net income was $3.3 million, or $0.10 per average diluted common share, compared to $2.8 million, or $0.09 per average diluted common share, for the three months ended June 30, 2013. The Company's annualized return on average assets was 0.91% and annualized return on average equity was 7.45% for the three months ended June 30, 2014, compared to 0.82% and 6.53%, respectively, a year ago.

For the six months ended June 30, 2014, net income available to common shareholders was $6.4 million, or $0.20 per average diluted common share, an increase from $5.0 million, or $0.16 per average diluted common share, for the six months ended June 30, 2013. The Company's annualized return on average assets was 0.88% and annualized return on average equity was 7.28% for the six months ended June 30, 2014, compared to 0.71% and 5.88%, respectively, a year ago.

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

- The net interest margin, on a fully tax equivalent ("FTE") basis, increased 18 basis points to 4.07% for the second quarter of 2014, from 3.89% for the second quarter of 2013, primarily due to loan growth, higher yields on securities, and a lower cost of funds. For the six months ended June 30, 2014, net interest margin increased 26 basis points to 4.06%, from 3.80% for the six months ended June 30, 2013, primarily due to loan growth, higher yields on securities, and a lower cost of funds.

The yield on the loan portfolio was 4.78% for the second quarter of 2014, compared to 4.93% for the second quarter of 2013. The yield on the loan portfolio was 4.82% for the six months ended June 30, 2014, compared to 5.03% for the six months ended June 30, 2013. The decrease in the yield on the loan portfolio for the second quarter and six months ended June 30, 2014 compared to the same periods in 2013 was a result of competitive market conditions.

Net interest income increased 13% to $13.7 million for the second quarter of 2014, compared to $12.2 million for the second quarter of 2013, driven primarily by loan growth and increases in core deposits. Net interest income increased 11% to $27.0 million for the six months ended June 30, 2014, compared to $24.3 million for the six months ended June 30, 2013.

There was a $198,000 credit to the provision for loan losses for the second quarter of 2014, compared to a $270,000 credit to the provision for loan losses for the second quarter of 2013. For the six months ended June 31, 2014, there was a $208,000 credit to the provision for loan losses, compared to a $270,000 credit to the provision for loan losses for the six months ended June 30. 2013.

Noninterest income was $2.0 million for the second quarter of 2014, compared to $1.9 million for the second quarter of 2013. For the six months ended June 30, 2014, noninterest income was $4.1 million, compared to $3.6 million for the six months June 30, 2013. Primarily due to higher gain on sales of SBA loans, noninterest income was higher for the second quarter and for the six months ended June 30, 2014, compared to the same periods in 2013.

Noninterest expense for the second quarter of 2014 was $10.9 million, an increase of 5% from $10.4 million for the second quarter of 2013. Noninterest expense for the six months ended June 30, 2014 increased 2% to $21.7 million, compared to $21.2 million for the six months ended June 30, 2013. The increase in noninterest expense for the second quarter and six months ended June 30, 2014 was primarily due to increased salaries and employee benefits expense, partially offset by lower professional fees. Higher salaries and employee benefits expense reflected the growth in staffing for business initiatives, the impact of merit increases, and costs associated with the reorganization of administrative responsibilities in the second quarter of 2014. Professional fees were lower due to net recoveries in legal fees as a result of the resolution or payoff of certain problem loans in the second quarter of 2014.

The efficiency ratio for the second quarter of 2014 improved to 69.50%, compared to 73.85% for the second quarter of 2013. The efficiency ratio for the six months ended June 30, 2014 was 69.71%, compared to 75.92% for the six months ended June 30, 2013. The decrease in the efficiency ratio in the second quarter and six months ended June 30, 2014, compared to the same periods in 2013, was primarily due to higher net interest income and noninterest income, partially offset by higher noninterest expense.

Income tax expense for the second quarter of 2014 was $1.7 million, compared to $1.2 million for the second quarter of 2013. The effective tax rate for the second quarter of 2014 increased to 33%, compared to 29% for the second quarter of 2013, primarily as a result of reduced income tax credits. Income tax expense for the six months ended June 30, 2014 was $3.2 million, compared to $2.0 million for the six months ended June 30, 2013. The effective tax rate for the six months ended June 30, 2014 was 33%, compared to 29% for the six months ended June 30, 2013. The difference in the effective tax rate for the periods reported, 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, and tax-exempt interest income earned on municipal bonds.

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

- Cash, Federal funds sold, interest-bearing deposits in other financial institutions and securities available-for-sale decreased 18% to $310.9 million at June 30, 2014, from $379.5 million at June 30, 2013, and decreased 21% from $392.7 million at December 31, 2013.

- Securities held-to-maturity, at amortized cost, were $96.0 million at June 30, 2014, compared to $81.7 million at June 30, 2013, and $95.9 million at December 31, 2013.

- Total loans, excluding loans held-for-sale, increased 18% to $990.3 million at June 30, 2014, from $842.0 million at June 30, 2013, and increased 8% from $914.9 million at December 31, 2013.

- Nonperforming assets were $8.7 million, or 0.59% of total assets, at June 30, 2014, compared to $15.0 million, or 1.07%, of total assets, at June 30, 2013, and $12.4 million, or 0.83% of total assets, at December 31, 2013.

- Classified assets, net of Small Business Administration ("SBA") guarantees, decreased 3% to $23.1 million at June 30, 2014, from $23.8 million at June 30, 2013, and decreased 2% from $23.6 million at December 31, 2013.

- Net charge-offs totaled $27,000 for the second quarter of 2014, compared to net recoveries of $270,000 for the second quarter 2013, and net charge-offs of $166,000 for the fourth quarter of 2013.

- The allowance for loan losses at June 30, 2014 was $18.6 million, or 1.88% of total loans, representing 228.35% of nonperforming loans. The allowance for loan losses at June 30, 2013 was $19.3 million, or 2.30% of total loans, representing 134.52% of nonperforming loans. The allowance for loan losses at December 31, 2013 was $19.2 million, or 2.09% of total loans, representing 162.16% of nonperforming loans.

- Deposits totaled $1.27 billion at June 30, 2014, compared to $1.19 billion at June 30, 2013, and $1.29 billion at December 31, 2013. Noninterest-bearing demand deposits increased $48.7 million at June 30, 2014 from June 30, 2013, and increased $25.2 million from December 31, 2013, while brokered deposits decreased $43.2 million and $21.9 million, respectively. Deposits (excluding all time deposits and CDARS deposits) increased $129.6 million, or 15%, to $1.0 billion at June 30, 2014, from $873.9 million at June 30, 2013 and increased $29.9 million, or 3%, from $973.6 million at December 31, 2013.

- 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 16.48% at June 30, 2014, compared to 20.87% at June 30, 2013, and 19.51% at December 31, 2013.

- The loan to deposit ratio was 78.11% at June 30, 2014, compared to 70.81% at June 30, 2013, and 71.13% at December 31, 2013.

- The Company announced it will pay a quarterly cash dividend of $0.05 per share in the third quarter of 2014 to holders of common stock and Series C Convertible Perpetual Preferred Stock ("Series C Preferred Stock"), on an as converted basis.

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Capital ratios exceed regulatory requirements for a well-capitalized financial institution, both on a consolidated basis and at the bank level at June 30, 2014:

Capital Ratios	Heritage Commerce Corp	Heritage Bank of Commerce	Well-Capitalized Financial Institution Regulatory Guidelines
Total Risk-Based	15.1%	14.1%	10.0%
Tier 1 Risk-Based	13.9%	12.9%	6.0%
Leverage	12.0%	11.2%	5.0%

Deposits

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

Deposits totaled $1.27 billion at June 30, 2014, compared to $1.19 billion at June 30, 2013, and $1.29 billion at December 31, 2013. Deposits (excluding all time deposits and CDARS deposits) increased $129.6 million, or 15%, to $1.0 billion at June 30, 2014, from $873.9 million at June 30, 2013, and increased $29.9 million, or 3%, from $973.6 million at December 31, 2013. 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 16.48% at June 30, 2014, compared to 20.87% at June 30, 2013, and 19.51% at December 31, 2013.

During the fourth quarter of 2013, the Company received $27.5 million in deposits from a law firm which were placed in a CDARS money market account. All of the $27.5 million in deposits from the law firm were withdrawn in January, 2014. The Company had $33.6 million in brokered deposits at June 30, 2014, compared to $76.8 million at June 30, 2013, and $55.5 million at December 31, 2013. Deposits from title insurance companies, escrow accounts and real estate exchange facilitators was $20.8 million at June 30, 2014, compared to $18.2 million at June 30, 2013, and $37.6 million at December 31, 2013. Certificates of deposit from the State of California totaled $98.0 million at June 30, 2014, June 30, 2013 and December 31, 2013.

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 June 30, 2014, we had $49.4 million in cash and cash equivalents and approximately $446.3 million in available borrowing capacity from various sources including the Federal Home Loan Bank ("FHLB"), the Federal Reserve Bank of San Francisco ("FRB"), and Federal funds facilities with several financial institutions. The Company also had $205.6 million in unpledged securities available at June 30, 2014. Our loan to deposit ratio increased to 78.11% at June 30, 2014, compared to 70.81% at June 30, 2013, and 71.13% at December 31, 2013.

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Lending

Our lending business originates principally through our branch offices located in our primary markets. Loans, excluding loans held-for-sale, increased 18% to $990.3 million at June 30, 2014, from $842.0 million at June 30, 2013, and increased 8% from $914.9 million at December 31, 2013. The loan portfolio remains well-diversified with commercial and industrial ("C&I") loans accounting for 42% of the loan portfolio at June 30, 2014. Commercial and residential real estate loans accounted for 46% of the total loan portfolio, of which 49% were owner-occupied by businesses. Consumer and home equity loans accounted for 7% of total loans, and land and construction loans accounted for the remaining 5% of total loans at June 30, 2014. C&I line usage was 42% at June 30, 2014, compared to 40% at June 30, 2013, and 41% at December 31, 2013.

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. 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 allowance for loan losses accordingly. However, because future events are uncertain, there may be loans that will 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. Additionally, Federal and state banking regulators, as an integral part of their supervisory function, periodically review our allowance for loan losses. These regulatory agencies may require us to recognize further loan loss provisions or charge-offs based upon their judgments, which may be different from ours. Any increase in the allowance for loan losses would have an adverse effect, which may be material, on our financial condition and results of operation.

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

Noninterest Income

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

Noninterest Expense

Management considers the control of operating expenses to be a critical element of the Company's performance. Noninterest expense for the second quarter of 2014 was $10.9 million, an increase of 5% from $10.4 million for the second quarter of 2013. Noninterest expense for the six months ended June 30, 2014 increased 2% to $21.7 million, compared to $21.2 million for the six months ended June 30, 2013. The increase in noninterest expense for the second quarter and six months ended June 30, 2014 was primarily due to increased salaries and employee benefits expense, partially offset by lower professional fees.

Capital Management

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

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

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

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

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

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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 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 which comprise the Company's earning assets, deposits, and other interest-bearing liabilities. To maintain its net interest margin the Company must manage the relationship between interest earned and paid.

The following Distribution, Rate and Yield table presents 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.

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Distribution, Rate and Yield

NET INTEREST INCOME AND NET INTEREST MARGIN	For the Three Months Ended June 30, 2014 Average Balance	Interest Income/ Expense	Average Yield/ Rate	For the Three Months Ended June 30, 2013 Average Balance	Interest Income/ Expense	Average Yield/ Rate
	(Dollars in thousands)					
Assets:						
Loans, gross(1)	$ 974,673	$ 11,617	4.78%	$ 817,565	$ 10,051	4.93%
Securities taxable	287,841	2,047	2.85%	358,532	2,399	2.68%
Securities tax exempt(2)	79,845	779	3.91%	58,474	550	3.77%
Federal funds sold and interest-bearing deposits in other financial institutions	31,598	22	0.28%	39,198	30	0.31%
Total interest earning assets(2)	1,373,957	14,465	4.22%	1,273,769	13,030	4.10%
Cash and due from banks	23,919			22,658		
Premises and equipment, net	7,212			7,611		
Intangible assets	1,367			1,830		
Other assets	62,630			67,334		
Total assets	$ 1,469,085			$ 1,373,202		
Liabilities and shareholders' equity:						
Deposits:						
Demand, noninterest-bearing	$ 436,018			$ 392,122		
Demand, interest-bearing	199,010	82	0.17%	167,726	57	0.14%
Savings and money market	354,826	166	0.19%	281,565	124	0.18%
Time deposits under $100	20,610	16	0.31%	23,292	21	0.36%
Time deposits $100 and over	194,483	157	0.32%	194,738	194	0.40%
Time deposits brokered	37,766	83	0.88%	81,118	197	0.97%
CDARS money market and time deposits	14,408	2	0.06%	17,918	2	0.04%
Total interest-bearing deposits	821,103	506	0.25%	766,357	595	0.31%
Total deposits	1,257,121	506	0.16%	1,158,479	595	0.21%
Subordinated debt				9,279	90	3.89%
Short-term borrowings	1,557	1	0.26%	288		0.00%
Total interest-bearing liabilities	822,660	507	0.25%	775,924	685	0.35%
Total interest-bearing liabilities and demand, noninterest-bearing / cost of funds	1,258,678	507	0.16%	1,168,046	685	0.24%
Other liabilities	31,444			33,681		

Total liabilities	1,290,122		1,201,727	
Shareholders' equity	178,963		171,475	
Total liabilities and shareholders' equity	$ 1,469,085		$ 1,373,202	
Net interest income(2) / margin	13,958	4.07%	12,345	3.89%
Less tax equivalent adjustment(2)	(273)		(192)	
Net interest income	$ 13,685		$ 12,153	

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

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

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NET INTEREST INCOME AND NET INTEREST MARGIN	For the Six Months Ended June 30, 2014 Average Balance	Interest Income/ Expense	Average Yield/ Rate	For the Six Months Ended June 30, 2013 Average Balance	Interest Income/ Expense	Average Yield/ Rate
	(Dollars in thousands)					
Assets:						
Loans, gross(1)	$ 952,628	$ 22,756	4.82%	$ 807,901	$ 20,140	5.03%
Securities taxable	287,946	4,217	2.95%	372,044	4,860	2.63%
Securities tax exempt(2)	79,895	1,557	3.93%	49,563	932	3.79%
Federal funds sold and interest-bearing deposits in other financial institutions	47,504	62	0.26%	77,858	99	0.26%
Total interest earning assets(2)	1,367,973	28,592	4.21%	1,307,366	26,031	4.02%
Cash and due from banks	24,323			23,104		
Premises and equipment, net	7,224			7,566		
Intangible assets	1,425			1,892		
Other assets	63,063			67,944		
Total assets	$ 1,464,008			$ 1,407,872		
Liabilities and shareholders' equity:						
Deposits:						
Demand, noninterest-bearing	$ 432,501			$ 426,424		
Demand, interest-bearing	199,207	159	0.16%	166,073	116	0.14%
Savings and money market	346,251	317	0.18%	282,392	244	0.17%
Time deposits under $100	20,887	33	0.32%	23,940	43	0.36%
Time deposits $100 and over	194,644	316	0.33%	192,518	398	0.42%
Time deposits brokered	43,384	199	0.92%	86,561	416	0.97%
CDARS money market and time deposits	16,770	3	0.04%	14,714	3	0.04%
Total interest-bearing deposits	821,143	1,027	0.25%	766,198	1,220	0.32%
Total deposits	1,253,644	1,027	0.17%	1,192,622	1,220	0.21%
Subordinated debt				9,279	178	3.87%
Short-term borrowings	812	1	0.25%	207	1	0.97%
Total interest-bearing liabilities	821,955	1,028	0.25%	775,684	1,399	0.36%
Total interest-bearing liabilities and demand, noninterest-bearing / cost of funds	1,254,456	1,028	0.17%	1,202,108	1,399	0.23%
Other liabilities	32,175			35,080		
Total liabilities	1,286,631			1,237,188		
Shareholders' equity	177,377			170,684		

Total liabilities and shareholders' equity	$ 1,464,008			$ 1,407,872		
Net interest income(2) / margin		27,564	4.06%		24,632	3.80%
Less tax equivalent adjustment(2)		(545)			(326)	
Net interest income		$ 27,019			$ 24,306	

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

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

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Volume and Rate Variances

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

	Three Months Ended June 30, 2014 vs. 2013 Increase (Decrease) Due to Change In:		
	Average Volume	Average Rate	Net Change
	(Dollars in thousands)		
Income from interest earning assets:			
Loans, gross	$ 1,874	$ (308)	$ 1,566
Securities taxable	(501)	149	(352)
Securities tax exempt(1)	209	20	229
Federal funds sold and interest-bearing deposits in other financial institutions	(5)	(3)	(8)
Total interest income from interest earnings assets(1)	1,577	(142)	1,435
Expense on interest-bearing liabilities:			
Demand, interest-bearing	11	14	25
Savings and money market	33	9	42
Time deposits under $100	(2)	(3)	(5)
Time deposits $100 and over	2	(39)	(37)
Time deposits brokered	(95)	(19)	(114)
CDARS money market and time deposits	(1)	1	
Subordinated debt	(90)		(90)
Short-term borrowings	1		1
Total interest expense on interest-bearing liabilities	(141)	(37)	(178)
Net interest income(1)	$ 1,718	$ (105)	1,613
Less tax equivalent adjustment(1)			(81)
Net interest income			$ 1,532

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

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	Six Months Ended June 30, 2014 vs. 2013 Increase (Decrease) Due to Change In: Average Volume	Average Rate	Net Change
	(Dollars in thousands)		
Income from interest earning assets:			
Loans, gross	$ 3,446	$ (830)	$ 2,616
Securities taxable	(1,226)	583	(643)
Securities tax exempt(1)	591	34	625
Federal funds sold and interest-bearing deposits in other financial institutions	(38)	1	(37)
Total interest income from interest earnings assets(1)	2,773	(212)	2,561
Expense on interest-bearing liabilities:			
Demand, interest-bearing	27	16	43
Savings and money market	65	8	73
Time deposits under $100	(5)	(5)	(10)
Time deposits $100 and over	1	(83)	(82)
Time deposits brokered	(196)	(21)	(217)
CDARS money market and time deposits			
Subordinated debt	(178)		(178)
Short-term borrowings	1	(1)	
Total interest expense on interest-bearing liabilities	(285)	(86)	(371)
Net interest income(1)	$ 3,058	$ (126)	2,932
Less tax equivalent adjustment(1)			(219)
Net interest income			$ 2,713

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

The Company's net interest margin (FTE), expressed as a percentage of average earning assets, increased 18 basis points to 4.07% for the second quarter of 2014, from 3.89% for the second quarter of 2013. For the six months ended June 30, 2014, net interest margin increased 26 basis points to 4.06%, from 3.80% for the six months ended June 30, 2013. The increase in the net interest margin for the second quarter and for the six months ended June 30, 2014, compared to the same periods in 2013, was primarily due to loan growth, higher yields on securities, and a lower cost of funds.

Net interest income increased 13% to $13.7 million for the second quarter of 2014, compared to $12.2 million for the second quarter of 2013. Net interest income increased 11% to $27.0 million for the six months ended June 30, 2014, compared to $24.3 million the six months ended June 30, 2013. The increase in the net interest income for the second quarter and for the six months ended June 30, 2014, compared to the same periods in 2013, was primarily due to loan growth and an increase in core deposits.

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, compared 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.

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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 presented in the statements of income 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 or excess, if any, to the current quarter's expense. 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.

There was a credit to the provision for loan losses of $198,000 for the second quarter of 2014, compared to a credit to the provision for loan losses of $270,000 for the second quarter of 2013. The credit to the provision for loan losses for the six months ended June 30, 2014 was $208,000, compared to a credit to the provision for loan losses $270,000 for the six months ended June 30,2013.

The allowance for loan losses totaled $18.6 million, or 1.88% of total loans at June 30, 2014, compared to $19.3 million, or 2.30% of total loans at June 30, 2013, and $19.2 million, or 2.09% of total loans at December 31, 2013. The allowance for loan losses to total loans decreased at June 30, 2014, compared to June 30, 2013, and December 31, 2013, primarily due to increasing loan balances with no default histories, improving the quality of the loan portfolio overall. Net charge-offs totaled $27,000 for the second quarter of 2014, compared to net recoveries of $270,000 for the second quarter of 2013, and net charge-offs of $166,000 for the fourth quarter of 2013. 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 for the periods indicated:

	For the Three Months Ended June 30,		Increase (decrease) 2014 versus 2013	
	2014	2013	Amount	Percent
	(Dollars in thousands)			
Service charges and fees on deposit accounts	$ 646	$ 618	$ 28	5%
Gain on sales of SBA loans	442	134	308	230%
Increase in cash surrender value of life insurance	397	410	(13)	-3%
Servicing income	313	385	(72)	-19%
Gain on sales of securities		7	(7)	-100%
Other	249	361	(112)	-31%
Total noninterest income	$ 2,047	$ 1,915	$ 132	7%

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	For the Six Months Ended June 30,		Increase (decrease) 2014 versus 2013	
	2014	2013	Amount	Percent
	(Dollars in thousands)			
Service charges and fees on deposit accounts	$ 1,266	$ 1,195	$ 71	6%
Gain on sales of SBA loans	599	270	329	122%
Increase in cash surrender value of life insurance	795	826	(31)	-4%
Servicing income	661	750	(89)	-12%
Gain on sales of securities	50	38	12	32%
Other	693	499	194	39%
Total noninterest income	$ 4,064	$ 3,578	$ 486	14%

The increase in noninterest income in the second quarter and six months ended June 30, 2014, compared to the same periods in 2013 was primarily attributable to a higher gain on sales of SBA loans.

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. For the three months ended June 30, 2014, SBA loan sales resulted in a $442,000 gain, compared to a $134,000 gain on sale of SBA loans for the three months ended June 30, 2013. For the six months ended June 30, 2014, SBA loan sales resulted in a $599,000 gain, compared to a $270,000 gain on sale of SBA loans for the six months ended June 30, 2013.

The servicing assets that result from the sales of SBA loans with servicing retained are amortized over the expected term of the loans using a method approximating the interest method. Servicing income generally declines as the respective loans are repaid.

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Noninterest Expense

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

	For the Three Months Ended June 30,		Increase (decrease) 2014 versus 2013	
	2014	2013	Amount	Percent
	(Dollars in thousands)			
Salaries and employee benefits	$ 6,819	$ 5,864	$ 955	16%
Occupancy and equipment	987	1,028	(41)	-4%
Data processing	273	327	(54)	-17%
Insurance expense	269	253	16	6%
FDIC deposit insurance premiums	220	207	13	6%
Software subscriptions	191	294	(103)	-35%
Correspondent bank charges	183	179	4	2%
Low income housing investment losses	165	300	(135)	-45%
Professional fees	126	400	(274)	-69%
Subordinated debt redemption charges		167	(167)	-100%
Foreclosed assets, net		(96)	96	-100%
Other	1,701	1,466	235	16%
Total noninterest expense	$ 10,934	$ 10,389	$ 545	5%

	For the Six Months Ended June 30,		Increase (decrease) 2014 versus 2013	
	2014	2013	Amount	Percent
	(Dollars in thousands)			
Salaries and employee benefits	$ 13,062	$ 11,875	$ 1,187	10%
Occupancy and equipment	1,932	2,096	(164)	-8%
Data processing	502	579	(77)	-13%
Insurance expense	538	508	30	6%
FDIC deposit insurance premiums	454	466	(12)	-3%
Software subscriptions	438	585	(147)	-25%
Correspondent bank charges	365	343	22	6%
Low income housing investment losses	353	611	(258)	-42%
Professional fees	712	1,382	(670)	-48%
Subordinated debt redemption charges		167	(167)	-100%
Foreclosed assets, net	(19)	(251)	232	-92%
Other	3,331	2,809	522	19%
Total noninterest expense	$ 21,668	$ 21,170	$ 498	2%

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

Noninterest Expense by Category

	For the Three Months Ended June 30,			
	2014	Percent of Total	2013	Percent of Total
	(Dollars in thousands)			
Salaries and employee benefits	$ 6,819	62%	$ 5,864	56%
Occupancy and equipment	987	9%	1,028	10%
Data processing	273	2%	327	3%
Insurance expense	269	2%	253	2%
FDIC deposit insurance premiums	220	2%	207	2%
Software subscriptions	191	2%	294	3%
Correspondent bank charges	183	2%	179	2%
Low income housing investment losses	165	2%	300	3%
Professional fees	126	1%	400	4%
Subordinated debt redemption charges		0%	167	2%
Foreclosed assets, net		0%	(96)	-1%
Other	1,701	16%	1,466	14%
Total noninterest expense	$ 10,934	100%	$ 10,389	100%

	For the Six Months Ended June 30,			
	2014	Percent of Total	2013	Percent of Total
	(Dollars in thousands)			
Salaries and employee benefits	$ 13,062	60%	$ 11,875	56%
Occupancy and equipment	1,932	9%	2,096	10%
Data processing	502	2%	579	3%
Insurance expense	538	3%	508	2%
FDIC deposit insurance premiums	454	2%	466	2%
Software subscriptions	438	2%	585	3%
Correspondent bank charges	365	2%	343	2%
Low income housing investment losses	353	2%	611	3%
Professional fees	712	3%	1,382	6%
Subordinated debt redemption charges		0%	167	1%
Foreclosed assets, net	(19)	0%	(251)	-1%
Other	3,331	15%	2,809	13%
Total noninterest expense	$ 21,668	100%	$ 21,170	100%

Noninterest expense for the second quarter of 2014 increased to $10.9 million, from $10.4 million for the second quarter of 2013. Noninterest expense for the six months ended June 30, 2014 was $21.7 million, compared to $21.2 million for the six months ended June 30, 2013. The increase in noninterest expense for the second quarter and six months ended June 30, 2014 compared to the same periods in 2013 was primarily due to increased salaries and employee benefits expense, partially offset by lower professional fees, data processing and software subscriptions, low income housing investment losses, and a $167,000 charge in the second quarter of 2013 related to the redemption of floating-rate subordinated debt. Higher salaries and employee benefits expense reflected the growth in staffing for business initiatives, the impact of merit increases, and costs associated with the reorganization of administrative responsibilities in the second quarter of 2014. Professional fees were lower due to net recoveries in legal fees as a result of the resolution or payoff of certain problem loans in the second quarter of 2014. Data processing and software subscriptions were lower mainly due to system conversion costs in the second quarter of 2013. Full time equivalent employees were 203 at June 30, 2014 and 191 at June 30, 2013.

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In the normal course of business, the Company becomes a party to financial instruments with off-balance sheet risk to meet the financing needs of its customers. These financial instruments include commitments to extend credit in the form of loans, or through commercial or standby letters of credit, and financial guarantees. These instruments represent varying degrees of exposure to risk in excess of the amounts included in the accompanying condensed consolidated balance sheets. The Company calculates an off-balance sheet credit risk reserve for all unfunded commitments.

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, increases in the cash surrender value of life insurance policies, California Enterprise Zone deductions, certain expenses that are not allowed as tax deductions, and tax credits.

The Company's Federal and state income tax expense for the quarter and six months ended June 30, 2014 was $1.7 million and $3.2 million, respectively. The income tax expense was $1.2 million and $2.0 million for the same periods in 2013. The following table shows the Company's effective income tax rates for the periods indicated:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2014	2013	2014	2013
Effective income tax rate	33.5%	29.3%	33.5%	28.8%

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

The Company has net investments of $874,000 in low-income housing limited partnerships as of June 30, 2014, generating tax credits of approximately $412,000 for 2014, compared to tax credits of approximately $727,000 for 2013. The Company had California Enterprise Zone tax savings of approximately $162,000 for 2013. The California state legislature eliminated the Enterprise Zone tax deductions beginning January 1, 2014.

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

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

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The Company had net deferred tax assets of $19.1 million and $23.3 million at June 30, 2014, and December 31, 2013, respectively. After consideration of the matters in the preceding paragraph, the Company determined that it is more likely than not that the net deferred tax asset at June 30, 2014 and December 31, 2013 will be fully realized in future years.

FINANCIAL CONDITION

As of June 30, 2014, total assets increased to $1.48 billion, compared to $1.40 billion at June 30, 2013, and decreased from $1.49 billion at December 31, 2013. Securities available-for-sale (at fair value) were $261.5 million at June 30, 2014, a decrease of 11% from $293.8 million at June 30, 2013, and a decrease of 7% from $280.1 million at December 31, 2013. Securities held-to-maturity (at amortized cost) were $96.0 million at June 30, 2014, compared to $81.7 million at June 30, 2013, and $95.9 million at December 31, 2013. The total loan portfolio, excluding loans held-for-sale, was $990.3 million at June 30, 2014, an increase of 18% from $842.0 million at June 30, 2013, and an increase of 8% from $914.9 million at December 31, 2013.

Deposits totaled $1.27 billion at June 30, 2014, compared to $1.19 billion at June 30, 2013, and $1.29 billion at December 31, 2013. Deposits (excluding all time deposits and CDARS deposits) increased $129.6 million, or 15%, to $1.0 billion at June 30, 2014, from $873.9 million at June 30, 2013, and increased $29.9 million, or 3%, from $973.6 million at December 31, 2013. There was no subordinated debt at June 30, 2014, compared to $9.3 million at June 30, 2013, and no subordinated debt at December 31, 2013.

Securities Portfolio

The following table reflects the balances for each category of securities at the dates indicated:

	June 30, 2014	June 30, 2013	December 31, 2013
	(Dollars in thousands)		
Securities available-for-sale (at fair value):			
Agency mortgage-backed securities	$ 158,996	$ 225,397	$ 207,644
Asset-backed securities	27,313		
Corporate bonds	53,868	47,646	52,046
Trust preferred securities	21,312	20,735	20,410
Total	$ 261,489	$ 293,778	$ 280,100
Securities held-to-maturity (at amortized cost):			
Agency mortgage-backed securities	$ 16,037	$ 14,211	$ 15,932
Municipals Tax Exempt	79,935	67,520	79,989
	$ 95,972	$ 81,731	$ 95,921

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The following table summarizes the weighted average life and weighted average yields of securities at June 30, 2014:

	Within One Year or Less		After One and Within Five Years		Weighted Average Life 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):										
Agency mortgage-backed securities	$		$ 60,833	2.69%	$ 98,163	2.84%	$		$ 158,996	2.78%
Asset-backed securities	1,790	1.13%	12,015	0.81%	13,508	0.68%			27,313	0.77%
Corporate bonds			6,677	2.77%	47,191	3.09%			53,868	3.05%
Trust preferred securities							21,312	4.87%	21,312	4.87%
	$ 1,790	1.13%	$ 79,525	2.41%	$ 158,862	2.73%	$ 21,312	4.87%	$ 261,489	2.80%
Securities held-to-maturity (at amortized cost):										
Agency mortgage-backed securities	$		$ 7,174	3.20%	$		$ 8,863	3.23%	$ 16,037	3.22%
Municipals Tax Exempt(1)			3,791	4.36%	22,031	4.08%	54,113	3.82%	79,935	3.92%
	$		$ 10,965	3.61%	$ 22,031	4.08%	$ 62,976	3.73%	$ 95,972	3.80%

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

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

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

The Company classifies its securities as either available-for-sale or held-to-maturity at the time of purchase. Accounting guidance requires available-for-sale securities to be marked to fair value with an offset to accumulated other comprehensive income (loss), a component of shareholders' equity. Monthly adjustments are made to reflect changes in the fair value of the Company's available-for-sale securities. The investment securities available-for-sale portfolio totaled $261.5 million at June 30, 2014, a decrease of 11% from $293.8 million at June 30, 2013, and a decrease of 7% from $280.1 million at December 31, 2013. At June 30, 2014, the investment securities available-for-sale portfolio was comprised of $159.0 million of agency mortgage-backed securities (all issued by U.S. Government sponsored entities), $53.9 million of corporate bonds, $27.3 million of asset-backed securities, and $21.3 million of single entity issue trust preferred securities.

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The investment securities held-to-maturity portfolio, at amortized cost, totaled $96.0 million at June 30, 2014, compared to $81.7 million at June 30, 2013, and $95.9 million at December 31, 2013. At June 30, 2014, the investment securities held-to-maturity portfolio was comprised of $80.0 million of tax-exempt municipal bonds, and $16.0 million of agency mortgage-backed securities.

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

Loans

The Company's loans represent the largest portion of invested 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 67% of total assets at June 30, 2014, 60% at June 30, 2013, and 61% of total assets at December 31, 2013. The ratio of loans to deposits increased to 78.11% at June 30, 2014, from 70.81% at June 30, 2013, and from 71.13% at December 31, 2013.

Loan Distribution

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

	June 30, 2014		June 30, 2013		December 31, 2013	
	Balance	% of Total	Balance	% of Total	Balance	% of Total
	(Dollars in thousands)					
Commercial	$ 415,557	42%	$ 383,068	46%	$ 393,074	43%
Real estate:						
Commercial and residential	454,676	46%	370,620	44%	423,288	46%
Land and construction	47,758	5%	26,705	3%	31,443	3%
Home equity	56,743	6%	48,667	6%	51,815	6%
Consumer	16,112	1%	13,097	1%	15,677	2%
Total loans	990,846	100%	842,157	100%	915,297	100%
Deferred loan (fees) costs, net	(505)		(207)		(384)	
Loans, including deferred fees and costs	990,341	100%	841,950	100%	914,913	100%
Allowance for loan losses	(18,592)		(19,342)		(19,164)	
Loans, net	$ 971,749		$ 822,608		$ 895,749	

The Company's loan portfolio is concentrated in commercial loans, primarily manufacturing, wholesale, and services, and commercial real estate, with the remaining balance in land development and construction, home equity and consumer loans. The Company does not have any concentrations by industry or group of industries in its loan portfolio, however, 57% of its gross loans were secured by real property at June 30, 2014, compared to 53% at June 30, 2013, and 55% at December 31, 2013. While no specific industry concentration is considered significant, the Company's lending operations are located in areas that are dependent on the technology and real estate industries and their supporting companies.

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

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

The Company is an active participant in the SBA and U.S. Department of Agriculture guaranteed lending programs, and has been approved by the SBA as a lender under the Preferred Lender Program. The Company regularly makes such 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 the second quarter and the six months ended June 30, 2014, loans were sold resulting in a gain on sale of SBA loans of $442,000 and $599,000, respectively.

As of June 30, 2014, commercial and residential real estate mortgage loans of $454.7 million consist primarily of adjustable and fixed-rate loans secured by deeds of trust on commercial and residential property. The real estate mortgage loans at June 30, 2014, consist of $222.1 million, or 49%, of commercial owner occupied properties, $232.6 million, or 51%, of commercial investment properties, and $473,000 (less than 1%) in residential properties. Properties securing the commercial real estate mortgage loans are generally located in the Company's primary market, which is the Greater San Francisco Bay Area.

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

The Company's land and construction loans are primarily to finance the development/construction of commercial and single family residential properties. The Company utilizes underwriting guidelines to assess the likelihood of repayment from sources such as sale of the property or availability of permanent mortgage financing prior to making the construction loan. Construction loans are provided only in our market area, and we have extensive controls for the disbursement process. The projects are typically infill construction in strong markets. Land and construction loans increased $21.1 million to $47.8 million, at June 30, 2014, from $26.7 million, at June 30, 2013, and increased $16.4 million from $31.4 million, at December 31, 2013, primarily as a result of strong housing demand within the Company's lending area.

The Company makes home equity lines of credit available to its existing customers. Home equity lines of credit are underwritten initially with a maximum 75% loan to value ratio. Home equity lines are reviewed at least semiannually, with specific emphasis on loans with a loan to value ratio greater than 70%. 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.

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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 $27.9 million and $46.4 million at June 30, 2014, respectively.

Loan Maturities

The following table presents the maturity distribution of the Company's loans (excluding loans held-for-sale) as of June 30, 2014. 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 June 30, 2014, approximately 58% of the Company's loan portfolio consisted of floating interest rate loans.

	Due in One Year or Less	Over One Year But Less than Five Years	Over Five Years	Total
	(Dollars in thousands)			
Commercial	$ 357,659	$ 50,967	$ 6,931	$ 415,557
Real estate:				
Commercial and residential	64,677	224,312	165,687	454,676
Land and construction	47,277	481		47,758
Home equity	51,828	1,703	3,212	56,743
Consumer	15,720	321	71	16,112
Loans	$ 537,161	$ 277,784	$ 175,901	$ 990,846
Loans with variable interest rates	$ 490,869	$ 73,356	$ 6,891	$ 571,116
Loans with fixed interest rates	46,292	204,428	169,010	419,730
Loans	$ 537,161	$ 277,784	$ 175,901	$ 990,846

Loan Servicing

As of June 30, 2014 and 2013, $136.1 million and $143.1 million, respectively, in SBA loans were serviced by the Company for others. Activity for loan servicing rights was as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2014	2013	2014	2013
	(Dollars in thousands)			
Beginning of period balance	$ 500	$ 670	$ 525	$ 709
Additions	185	29	224	58
Amortization	(79)	(68)	(143)	(136)
End of period balance	$ 606	$ 631	$ 606	$ 631

Loan servicing rights are included in accrued interest receivable and other assets on the unaudited consolidated balance sheets and reported net of amortization. There was no valuation allowance as of June 30, 2014 and 2013, as the fair value of the assets was greater than the carrying value.

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Activity for the I/O strip receivable was as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2014	2013	2014	2013
	(Dollars in thousands)			
Beginning of period balance	$ 1,664	$ 1,777	$ 1,647	$ 1,786
Unrealized holding loss	(31)	(51)	(14)	(60)
End of period balance	$ 1,633	$ 1,726	$ 1,633	$ 1,726

Credit Quality

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

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

	June 30, 2014	June 30, 2013	December 31, 2013
	(Dollars in thousands)		
Nonaccrual loans held-for-investment	$ 7,688	$ 13,868	$ 11,326
Restructured and loans over 90 days past due and still accruing	454	510	492
Total nonperforming loans	8,142	14,378	11,818
Foreclosed assets	525	659	575
Total nonperforming assets	$ 8,667	$ 15,037	$ 12,393
Nonperforming assets as a percentage of loans plus foreclosed assets	0.87%	1.78%	1.35%
Nonperforming assets as a percentage of total assets	0.59%	1.07%	0.83%

The following table presents nonperforming loans by class at the dates indicated:

	June 30, 2014			December 31, 2013		
	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	$ 3,729	$ 454	$ 4,183	$ 4,414	$ 492	$ 4,906
Real estate:						
Commercial and residential	1,693		1,693	4,363		4,363
Land and construction	1,688		1,688	1,761		1,761
Home equity	546		546	666		666
Consumer	32		32	122		122
Total	$ 7,688	$ 454	$ 8,142	$ 11,326	$ 492	$ 11,818

Nonperforming assets were $8.7 million, or 0.59% of total assets, at June 30, 2014, compared to $15.0 million, or 1.07% of total assets, at June 30, 2013, and $12.4 million, or 0.83% of total assets, at December 31, 2013. Included in total nonperforming assets were foreclosed assets of $525,000 at June 30, 2014, compared to $659,000 at June 30, 2013, and $575,000 at December 31, 2013. The decline in nonperforming assets at June 30, 2014 was primarily due to loan payoffs, charge-offs, and upgrades in nonperforming loans' risk categories.

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

	June 30, 2014			June 30, 2013			December 31, 2013		
	Nonclassified	Classified*	Total	Nonclassified	Classified*	Total	Nonclassified	Classified*	Total
	(Dollars in thousands)								
Commercial	$ 405,575	$ 9,982	$ 415,557	$ 372,077	$ 10,991	$ 383,068	$ 380,806	$ 12,268	$ 393,074

Real estate:									
Commercial and residential	446,287	8,389	454,676	363,222	7,398	370,620	416,992	6,296	423,288
Land and construction	46,070	1,688	47,758	24,576	2,129	26,705	29,682	1,761	31,443
Home equity	53,885	2,858	56,743	45,974	2,693	48,667	48,818	2,997	51,815
Consumer	15,872	240	16,112	12,729	368	13,097	15,336	341	15,677
Total	$ 967,689	$ 23,157	$ 990,846	$ 818,578	$ 23,579	$ 842,157	$ 891,634	$ 23,663	$ 915,297

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

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

	Six Months Ended June 30, 2014		
	Performing TDRs	Nonperforming TDRs	Total
	(Dollars in thousands)		
Balance at January 1, 2014	$ 492	$ 3,230	$ 3,722
Principal repayments/advances/upgrades	(8)	(560)	(568)
Net charge-offs	(30)		(30)
Change in TDR classification	1,180	(1,180)	
Balance at June 30, 2014	$ 1,634	$ 1,490	$ 3,124

	Six Months Ended June 30, 2013		
	Performing TDRs	Nonperforming TDRs	Total
	(Dollars in thousands)		
Balance at January 1, 2013	$ 2,309	$ 1,798	$ 4,107
Principal repayments/advances/upgrades	(914)	(62)	(976)
Net charge-offs		(372)	(372)
Change in TDR classification	(217)	217	
Balance at June, 2013	$ 1,178	$ 1,581	$ 2,759

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 collectability 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

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prior loss experience, the Company uses quantifiable observable industry data to determine the probability of default and loss given default.

Loans that demonstrate a weakness for which there is a possibility of loss if the weakness is not corrected, are categorized as "classified." Classified assets include all loans considered as substandard, substandard-nonaccrual, and doubtful and may result from problems specific to a borrower's business or from economic downturns that affect the borrower's ability to repay or that cause a decline in the value of the underlying collateral (particularly real estate), and foreclosed assets. The principal balance of classified assets, net of SBA guarantees, was $23.1 million at June 30, 2014, $23.8 million at June 30, 2013, and $23.6 million at December 31, 2013. Loans held-for-sale are carried at the lower of cost or estimated fair value, and are not allocated an allowance for loan losses.

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

The following tables summarize 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:

	Three Months Ended June 30, 2014			
	Commercial	**Real Estate**	**Consumer**	**Total**
	(Dollars in thousands)			
Balance, beginning of period	$ 11,846	$ 6,894	$ 77	$ 18,817
Charge-offs	(187)			(187)
Recoveries	144	16		160
Net (charge-offs) recoveries	(43)	16		(27)
Provision (credit) for loan losses	(349)	159	(8)	(198)
Balance, end of period	$ 11,454	$ 7,069	$ 69	$ 18,592
RATIOS:				
Annualized net charge-offs (recoveries) to average loans(1)	0.02%	-0.01%	0.00%	0.01%
Allowance for loan losses to total loans(1)	1.16%	0.71%	0.01%	1.88%
Allowance for loan losses to nonperforming loans	140.68%	86.82%	0.85%	228.35%

(1) Average loans and total loans exclude loans held-for-sale.

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	Three Months Ended June 30, 2013			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	$ 12,455	$ 6,770	$ 117	$ 19,342
Charge-offs	(119)	(56)		(175)
Recoveries	188	257		445
Net recoveries	69	201		270
Provision (credit) for loan losses	287	(583)	26	(270)
Balance, end of period	$ 12,811	$ 6,388	$ 143	$ 19,342
RATIOS:				
Annualized net recoveries to average loans(1)	0.03%	0.10%	0.00%	0.13%
Allowance for loan losses to total loans(1)	1.52%	0.76%	0.02%	2.30%
Allowance for loan losses to nonperforming loans	89.10%	44.43%	0.99%	134.52%

	Six Months Ended June 30, 2014			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	$ 12,533	$ 6,548	$ 83	$ 19,164
Charge-offs	(595)			(595)
Recoveries	188	43		231
Net (charge-offs) recoveries	(407)	43		(364)
Provision (credit) for loan losses	(672)	478	(14)	(208)
Balance, end of period	$ 11,454	$ 7,069	$ 69	$ 18,592
RATIOS:				
Annualized net charge-offs (recoveries) to average loans(1)	0.09%	-0.01%	0.00%	0.08%
Allowance for loan losses to total loans(1)	1.16%	0.71%	0.01%	1.88%
Allowance for loan losses to nonperforming loans	140.68%	86.82%	0.85%	228.35%

	Six Months Ended June 30, 2013			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	$ 12,866	$ 6,034	$ 127	$ 19,027
Charge-offs	(959)	(56)		(1,015)
Recoveries	1,338	262		1,600

Net (charge-offs) recoveries		379		206				585
Provision (credit) for loan losses		(434)		148		16		(270)
Balance, end of period	$	12,811	$	6,388	$	143	$	19,342
RATIOS:								
Annualized net charge-offs (recoveries) to average loans(1)		0.10%		0.05%		0.00%		0.15%
Allowance for loan losses to total loans(1)		1.52%		0.76%		0.02%		2.30%
Allowance for loan losses to nonperforming loans		89.10%		44.43%		0.99%		134.52%

(1) Average loans and total loans exclude loans held-for-sale.

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The following table provides a summary of the allocation of the allowance for loan losses by class 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 classes.

Allocation of Allowance for Loan Losses

	June 30, 2014		June 30, 2013		December 31, 2013	
	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	$ 11,454	42%	$ 12,811	46%	$ 12,533	43%
Real estate:						
Commercial and residential	4,862	46%	4,949	44%	4,922	46%
Land and construction	755	5%	280	3%	356	3%
Home equity	1,452	6%	1,159	6%	1,270	6%
Consumer	69	1%	143	1%	83	2%
Total	$ 18,592	100%	$ 19,342	100%	$ 19,164	100%

The allowance for loan losses totaled $18.6 million, or 1.88% of total loans at June 30, 2014, compared to $19.3 million, or 2.30% of total loans at June 30, 2013, and $19.2 million, or 2.09% of total loans at December 31, 2013. The allowance for loan losses to total loans decreased at June 30, 2014, compared to June 30, 2013, and December 31, 2013, primarily due to increasing loan balances with no default histories, improving the quality of the loan portfolio overall. Loan charge-offs reflect the realization of losses in the portfolio that were partially recognized previously through the provision for loan losses. The Company had net charge-offs of $27,000, or 0.01% of average loans, for the second quarter of 2014, compared to net recoveries of $270,000, or 0.13% of average loans, for the second quarter of 2013, and net charge-offs of $166,000, or 0.07% of average loans, for the fourth quarter of 2013.

The allowance for loan losses related to the commercial portfolio decreased $1.1 million at June 30, 2014 from December 31, 2013, as a result of a credit to the provision for loan losses of $672,000 and net charge-offs of $407,000. The decrease in the allowance for loan losses was primarily due to a decline in problem loans. The allowance for loan losses related to the real estate portfolio increased $521,000 at June 30, 2014 from December 31, 2013, as a result of a provision for loan losses of $478,000 and net recoveries of $43,000. The increase in the allowance for loan losses was primarily due to an increase in the balance of real estate loans outstanding, partially offset by a decline in problem loans.

Deposits

The composition and cost of the Company's deposit base are important components in analyzing the Company's net interest margin and balance sheet liquidity characteristics, both of which are discussed in greater detail in other sections herein. The Company's liquidity is impacted by the volatility of deposits from the propensity of that money to leave the institution for rate-related or other reasons. Deposits can be adversely affected if economic conditions in California, and the Company's market area in particular, weaken. Potentially, the most volatile deposits in a financial institution are jumbo

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certificates of deposit, meaning time deposits with balances that equal or exceed $100,000, as customers with balances of that magnitude are typically more rate-sensitive than customers with smaller balances.

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

	June 30, 2014		June 30, 2013		December 31, 2013	
	Balance	% to Total	Balance	% to Total	Balance	% to Total
	(Dollars in thousands)					
Demand, noninterest-bearing	$ 456,235	36%	$ 407,516	34%	$ 431,085	34%
Demand, interest-bearing	193,041	15%	171,027	14%	195,451	15%
Savings and money market	354,175	28%	295,336	25%	347,052	27%
Time deposits under $100	20,379	2%	23,062	2%	21,646	2%
Time deposits $100 and over	195,619	15%	197,718	17%	195,005	15%
Time deposits brokered	33,614	3%	76,800	6%	55,524	4%
CDARS money market and time deposits	14,785	1%	17,580	2%	40,458	3%
Total deposits	$ 1,267,848	100%	$ 1,189,039	100%	$ 1,286,221	100%

The Company obtains deposits from a cross-section of the communities it serves. The Company's business is not generally seasonal in nature. Public funds were 8% of deposits at June 30, 2014, 8% at June 30, 2013, and 9% at December 31, 2013.

Total deposits increased $78.8 million to $1.27 billion at June 30, 2014, from $1.19 billion at June 30, 2013, while brokered deposits decreased $43.2 million during this period. Total deposits decreased $18.4 million at June 30, 2014 from $1.29 billion at December 31, 2013, primarily due to a decrease in brokered deposits of $21.9 million and a decrease of $25.7 million in CDARS deposits, partially offset by an increase in core deposits. During the fourth quarter of 2013, the Company received $27.5 million in deposits from a law firm which were placed in a CDARS money market account. All of the $27.5 million in deposits from the law firm were withdrawn in January, 2014. Deposits (excluding all time deposits and CDARS deposits) increased $126.9 million, or 15%, to $1.0 billion at June 30, 2014, from $873.9 million at June 30, 2013, and increased $29.9 million, or 3%, from $973.6 million at December 31, 2013.

At June 30, 2014, the Company had $108.1 million (at fair value) of securities pledged for $98.0 million in certificates of deposits from the State of California. At June 30, 2013, the Company had $108.4 million (at fair value) of securities pledged for $98.0 million in certificates of deposits from the State of California. At December 31, 2013, the Company had $108.0 million (at fair value) of securities pledged for $98.0 million in certificates of deposits from the State of California.

CDARS deposits were comprised of $6.9 million of money market accounts and $7.9 million of time deposits at June 30, 2014. CDARS deposits were comprised of $9.0 million of money market accounts and $8.6 million of time deposits at June 30, 2013. CDARS deposits were comprised of $34.8 million of money market accounts and $5.7 million of time deposits at December 31, 2013.

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The following table indicates the contractual maturity schedule of the Company's time deposits of $100,000 and over, and all CDARS time deposits and brokered deposits as of June 30, 2014:

	Balance	% of Total
	(Dollars in thousands)	
Three months or less	$ 104,913	44%
Over three months through six months	63,407	27%
Over six months through twelve months	34,801	15%
Over twelve months	34,047	14%
Total	$ 237,168	100%

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

Return on Equity and Assets

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Annualized return on average assets	0.91%	0.82%	0.88%	0.71%
Annualized return on average tangible assets	0.91%	0.82%	0.88%	0.71%
Annualized return on average equity	7.45%	6.53%	7.28%	5.88%
Annualized return on average tangible equity	7.51%	6.60%	7.33%	5.94%
Dividend payout ratio(1)	38.51%	N/A	39.97%	N/A
Average equity to average assets ratio	12.18%	12.49%	12.12%	12.12%

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

Off-Balance Sheet Arrangements

In the normal course of business, the Company makes commitments to extend credit to its customers as long as there are no violations of any conditions established in the contractual arrangements. These commitments are obligations that represent a potential credit risk to the Company, but are not reflected on the Company's consolidated balance sheets. Total unused commitments to extend credit were $396.0 million June 30, 2014, compared to $349.4 million at June 30, 2013, and $377.2 million at December 31, 2013. Unused commitments represented 40%, 41%, and 41% of outstanding gross loans at June 30, 2014, June 30, 2013, and December 31, 2013, respectively.

The effect on the Company's revenues, expenses, cash flows and liquidity from the unused portion of the commitments to provide credit cannot be reasonably predicted because there is no certainty that

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lines of credit and letters of credit will ever be fully utilized. The following table presents the Company's commitments to extend credit for the periods indicated:

	June 30, 2014		June 30, 2013		December 31, 2013	
	Fixed Rate	Variable Rate	Fixed Rate	Variable Rate	Fixed Rate	Variable Rate
	(Dollars in thousands)					
Unused lines of credit and commitments to make loans	$ 8,104	$ 376,558	$ 5,683	$ 330,870	$ 6,136	$ 359,955
Standby letters of credit		11,370	2,775	10,030		11,099
	$ 8,104	$ 387,928	$ 8,458	$ 340,900	$ 6,136	$ 371,054

Liquidity and Asset/Liability Management

Liquidity refers to the Company's ability to maintain cash flows sufficient to fund operations and to meet obligations and other commitments in a timely and cost effective fashion. At various times the Company requires funds to meet short-term cash requirements brought about by loan growth or deposit outflows, the purchase of assets, or liability repayments. An integral part of the Company's ability to manage its liquidity position appropriately is the Company's large base of core deposits, which are generated by offering traditional banking services in its service area and which have historically been a stable source of funds. To manage liquidity needs properly, cash inflows must be timed to coincide with anticipated outflows or sufficient liquidity resources must be available to meet varying demands. The Company manages liquidity to be able to meet unexpected sudden changes in levels of its assets or deposit liabilities without maintaining excessive amounts of balance sheet liquidity. Excess balance sheet liquidity can negatively impact the Company's interest margin. In order to meet short-term liquidity needs the Company utilizes overnight Federal funds purchase arrangements and other borrowing arrangements with correspondent banks, solicits brokered deposits if cost effective deposits are not available from local sources and maintains collateralized lines of credit with the FHLB and FRB. In addition, the Company can raise cash for temporary needs by selling securities under agreements to repurchase and selling securities available-for-sale.

One of the measures we analyze for liquidity is our loan to deposit ratio. Our loan to deposit ratio was 78.11% at June 30, 2014, compared to 70.81% at June 30, 2013, and 71.13% at December 31, 2013.

FHLB and FRB Borrowings and Available Lines of Credit

The Company has off-balance sheet liquidity in the form of Federal funds purchase arrangements with correspondent banks, including the FHLB and FRB. The Company can borrow from the FHLB on a short-term (typically overnight) or long-term (over one year) basis. The Company had no overnight borrowings from the FHLB at June 30, 2014, June 30, 2013 and December 31, 2013. The Company had $261.2 million of loans pledged to the FHLB as collateral on an available line of credit of $137.7 million at June 30, 2014.

The Company can also borrow from the FRB's discount window. The Company had $339.9 million of loans pledged to the FRB as collateral on an available line of credit of $253.6 million at June 30, 2014, none of which was outstanding.

At June 30, 2014, the Company had Federal funds purchase arrangements available of $55.0 million. There were no Federal funds purchased outstanding at June 30, 2014, June 30, 2013 and December 31, 2013.

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The Company may also utilize securities sold under repurchase agreements to manage our liquidity position. There were no securities sold under agreements to repurchase June 30, 2014, June 30, 2013, and December 31, 2013.

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

	June 30, 2014	June 30, 2013	December 31, 2013
	(Dollars in thousands)		
Average balance year-to-date	$ 773	$	$ 58
Average interest rate year-to-date	0.12%	N/A	0.20%
Maximum month-end balance during the quarter	$ 5,000	$	$
Average rate at period-end	N/A		