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

Form 10-K

(Mark One)

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

For the fiscal year ended December 31, 2002

or

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

For the transition period from to

Commission file number 000-23877

Heritage Commerce Corp

(Exact name of Registrant as Specified in its Charter)

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

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

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

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

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

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

COMMON STOCK (NO PAR VALUE)
PREFERRED SHARE PURCHASE RIGHTS

(Title of class)

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

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

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes No

The aggregate market value of the stock held by non-affiliates of the Registrant, based upon the closing price of its common stock as of June 28, 2002 (\$9.60 per share), as reported on the Nasdaq National Market System, was approximately \$99.5 million.

As of March 25, 2003, there were 11,222,564 shares of the Registrant's common stock (no par value) outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

DOCUMENTS INCORPORATED

Definitive proxy statement for the Company's 2003 Annual Meeting of Shareholders to be filed within 120 days of the end of the fiscal year ended December 31, 2002.

PARTS OF FORM 10-K INTO WHICH INCORPORATED

Part III

HERITAGE COMMERCE CORP
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FOR YEAR ENDED DECEMBER 31, 2002

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PART I

Item 1 *Business*

Discussions of certain matters in this Report on Form 10-K 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 (the “Exchange Act”), and as such, may involve risks and uncertainties. Forward-looking statements, which are based on certain assumptions and describe future plans, strategies, and expectations, are generally identifiable by the use of words such as “believe”, “expect”, “intend”, “anticipate”, “estimate”, “project”, “assume,” “plan,” “predict,” “forecast” or similar expressions. These forward-looking statements relate to, among other things, expectations of the business environment in which the Company operates, projections of future performance, potential future performance, potential future credit experience, perceived opportunities in the market, and statements regarding the Company’s mission and vision. The Company’s actual results, performance, and achievements may differ materially from the results, performance, and achievements expressed or implied in such forward-looking statements due to a wide range of factors. The factors include, but are not limited to changes in interest rates, general economic conditions, legislative and regulatory changes, monetary and fiscal policies of the US Government, real estate valuations, competition in the financial services industry, and other risks. All of the Company’s operations and most of its customers are located in California. In addition, other events, including those of September 11, 2001, the threat of terrorism or the impact of potential military conflicts have increased the uncertainty related to the national and California economic outlook and could have an effect on the future operations of the Company or its customers, including borrowers. The Company does not undertake, and specifically disclaims any obligation, to update any forward-looking statements to reflect occurrences or unanticipated events or circumstances after the date of such statements.

General

Heritage Commerce Corp (the “Company”) is registered with the Board of Governors of the Federal Reserve System (“FRB”) as a Bank Holding Company under the Bank Holding Company Act (“BHCA”). The Company was organized in 1997 to be the holding Company for Heritage Bank of Commerce (“HBC”). In 1998 the Company also became the holding Company for Heritage Bank East Bay (“HBEB”); in January 2000 the Company became the holding Company for Heritage Bank South Valley (“HBSV”); and in October 2000 the Company became the holding Company for Bank of Los Altos (“BLA”). HBC, HBEB, HBSV, and BLA are sometimes collectively referred to herein as the “Banks”.

During 2002, the Company’s Board of Directors approved the merger of three of its wholly owned commercial bank subsidiaries into the Company’s original wholly owned bank subsidiary, HBC. On January 1, 2003, HBEB, HBSV, and BLA were merged into HBC. The former HBEB, HBSV, and BLA now operate as divisions of HBC and continue to serve their local markets and communities under their current names.

The Internet address of the Company’s website is “<http://www.heritagecommercecorp.com>.” In 1998 the Company began making available free of charge through the Company’s website, the Company’s annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to these reports. The Company makes these reports available on its website on the same day they appear on the SEC’s website.

On June 6, 2001, HBSV opened a full service branch in Gilroy, California. The Gilroy office offers a complete line of custom tailored business and personal banking services and products.

General Banking Services

The Company’s customer base consists primarily of small to medium-sized businesses and their owners, managers, and employees residing in Santa Clara, Alameda, and Contra Costa counties. Businesses served include manufacturers, distributors, contractors, professional corporations/partnerships, and service businesses. The Company had approximately 14,900 deposit accounts at December 31, 2002.

The Company offers a range of loans, primarily commercial, including real estate, construction, Small Business Administration (SBA), inventory and accounts receivable, and equipment loans. The Company also accepts checking, savings, and time deposits; NOW and money market deposit accounts; and provides travelers' checks, safe deposit, and other customary non-deposit banking services. The Company does not have a trust department.

HBC's main and executive offices and the Company's offices are located at 150 Almaden Boulevard, San Jose, California 95113. In addition, HBEB is located at 3077 Stevenson Blvd., Fremont, California 94538, HBSV is located at 18625 Sutter Drive, Morgan Hill, California 95037, and BLA is located at 4546 El Camino Real, Los Altos, California 94022. See Item 2 — "PROPERTIES." The Company's primary market area is Santa Clara, Alameda, and Contra Costa counties. The Company serves a secondary market consisting of the South Bay portion of the San Francisco Bay area and portions of other counties contiguous to its primary market area.

Recent management change

Effective February 1, 2003, the Company's Board of Directors elected Mr. Phillip R. Boyce as Chairman of the Board of Heritage Commerce Corp and its subsidiary bank, HBC. Mr. Brad L. Smith remains CEO of Heritage Commerce Corp and was appointed CEO of HBC by the Board of Directors at their January 2003 meeting. Mr. John McGrath remains President of HBC.

William Nethercott, Lane Lawson, and Robert Holden remain as President and CEO of HBEB, HBSV, and BLA divisions, which will continue to serve their local markets and communities.

In November 2002 Philip L. Griffin, the Company's Chief Information Officer, was promoted to Executive Vice President. Mr. Griffin joined the Company as a Senior Vice President in October 2000, and oversees the Company's Information/Data Services function.

Competition

The banking and financial services business in California generally, and in the Company's market areas specifically, is highly competitive. The increasingly competitive environment is a result primarily of changes in regulation, changes in technology and product delivery systems, and the consolidation among financial service providers. The Company competes for loans, deposits and customers for financial services with other commercial banks, savings and loan associations, securities and brokerage companies, mortgage companies, insurance companies, finance companies, money market funds, credit unions, and other non-bank financial service providers. Many of these competitors are much larger in total assets and capitalization, have greater access to capital markets and offer a broader array of financial services than the Company. In order to compete with the other financial service providers, the Company principally relies upon local promotional activities, personal relationships established by officers, directors, and employees with its customers, and specialized services tailored to meet its customers' needs. In those instances where the Company is unable to accommodate a customer's needs, the Company seeks to arrange for such loans on a participation basis with other financial institutions or to have those services provided in whole or in part by its correspondent banks. See Item 1 — "BUSINESS — Supervision And Regulation."

Supervision and Regulation

General

Bank holding companies and banks are extensively regulated under both federal and state law. This regulation is intended primarily for the protection of depositors and the deposit insurance fund and not for the benefit of stockholders of the Company. Set forth below is a summary of certain laws that relate to the regulation of the Company and HBC. The description does not purport to be complete and is qualified in its entirety by reference to the applicable laws and regulations.

As a registered bank holding company, the Company is subject to the supervision of, and regular inspection by, the Federal Reserve Board (FRB). Historically the activities of bank holding companies, such

as the Company, have been limited by the BHCA to banking, managing or controlling banks, furnishing services to or performing services for their subsidiaries, or any other activity which the FRB deems to be so closely related to banking or managing or controlling banks as to be a proper incident thereto. In making such determinations, the FRB is required to consider whether the performance of such activities by a bank holding company or its subsidiaries can reasonably be expected to produce benefits to the public such as greater convenience, increased competition, or gains in efficiency that outweigh the possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices. Generally, bank holding companies are required to give notice to or obtain prior approval from FRB to engage in any new activity or to acquire more than 5% of any class of voting stock of any bank. For discussion of the expansion of the powers of bank holding companies, see “Gramm-Leach-Bliley Act” below. The Company is also a bank holding company within the meaning of Section 3700 of the California Financial Code. As such, the Company and its subsidiary, HBC, are subject to examination by, and may be required to file reports with, the California Department of Financial Institutions (the “Department”).

The Company’s common stock is registered with the Securities and Exchange Commission (“SEC”) under the Securities Exchange Act of 1934, as amended (the “Exchange Act”). As such, the Company is subject to the information, proxy solicitation, insider trading, and other requirements and restrictions of the Exchange Act.

Deposit accounts at HBC are insured by the Federal Deposit Insurance Corporation (FDIC), which currently insures deposits to a maximum of \$100,000 per depositor. For this protection, HBC pays a semi-annual assessment and are subject to the rules and regulations of the FDIC pertaining to deposit insurance and other matters.

As of January 1, 2003, the Company completed the merger of three of its wholly owned commercial bank subsidiaries into HBC, the Company’s first and largest bank in San Jose. HBEB, HBSV and BLA became divisions of HBC and will continue to serve their local markets and communities. As of December 31, 2002, HBC, HBEB, HBSV, and BLA were California state-chartered banks and members of the Federal Reserve System; subsequent to the mergers, HBC remains a California state-chartered member bank. State banks chartered in California that are members of the FRB are subject to regulation, supervision and regular examination by the Department and by the FRB. The regulations of the Department and the FRB continue to govern most aspects of HBC’s business, including reporting requirements, activities, investments, loans, borrowings, certain check-clearing activities, branching, mergers and acquisitions, reserves against deposits, and other areas.

Gramm-Leach-Bliley Act

The Gramm-Leach-Bliley Act of 1999 (the “GLB Act”) became effective March 11, 2000. The GLB Act repeals two provisions of the Glass-Steagall Act: Section 20, which restricted the affiliation of Federal Reserve Member Banks with firms “engaged principally” in specified securities activities; and Section 32, which restricts officer, director, or employee interlocks between a member bank and any Company or person “primarily engaged” in specified securities activities. In addition, the GLB Act also contains provisions that expressly preempt any state law restricting the establishment of financial affiliations, primarily related to insurance. The general effect of the law is to establish a comprehensive framework to permit affiliations among commercial banks, insurance companies, securities firms, and other financial service providers by revising and expanding the BHCA framework to permit a holding company system to engage in a full range of financial activities through a new entity known as a Financial Holding Company. “Financial activities” is broadly defined to include not only banking, insurance, and securities activities, but also merchant banking and additional activities that the Federal Reserve, in consultation with the Secretary of the Treasury, determines to be financial in nature, incidental to such financial activities, or complementary activities that do not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally.

Generally, the GLB Act:

- Repeals historical restrictions on, and eliminates many federal and state law barriers to, affiliations among banks, securities firms, insurance companies, and other financial service providers;

- Provides a uniform framework for the functional regulation of the activities of banks, savings institutions, and their holding companies;
- Broadens the activities that may be conducted by national banks, banking subsidiaries of bank holding companies, and their financial subsidiaries;
- Provides an enhanced framework for protecting the privacy of consumer information;
- Adopts a number of provisions related to capitalization, membership, corporate governance, and other measures designed to modernize the Federal Home Loan Bank system;
- Modifies the laws governing the implementation of the Community Reinvestment Act (“CRA”); and
- Addresses a variety of other legal and regulatory issues affecting both day-to-day operations and long-term activities of financial institutions.

In order for the Company to take advantage of the ability to affiliate with other financial services providers, the Company must become a “Financial Holding Company” as permitted under an amendment to BHCA. To become a Financial Holding Company, the Company would file a declaration with the FRB, electing to engage in activities permissible for Financial Holding Companies and certifying that it is eligible to do so because its insured depository institution subsidiary is well-capitalized and well-managed. In addition, the FRB must also determine that the insured depository institution subsidiary of the Company has at least a “Satisfactory” CRA rating. The Company currently meets the requirements to make an election to become a Financial Holding Company. The Company’s management has not determined at this time whether it will seek an election to become a Financial Holding Company. The Company is examining its strategic business plan to determine whether, based on market conditions, the relative financial conditions of the company and its subsidiaries, regulatory capital requirements, general economic conditions, and other factors, the Company desires to utilize any of the expanded powers provided in the GLB Act.

The GLB Act also permits national banks to engage in expanded activities through the formation of financial subsidiaries. A national bank may engage, subject to limitations on investment, in activities that are financial in nature, other than insurance underwriting, insurance Company portfolio investment, real estate development, real estate investment, or merchant banking, all of which may only be conducted through a subsidiary of a Financial Holding Company. Financial activities include all activities permitted under new sections of the BHCA or permitted by regulation.

A national bank seeking to have a financial subsidiary, and each of its depository institution affiliates, must be “well-capitalized” and “well-managed.” The total assets of all financial subsidiaries may not exceed the lesser of 45% of a bank’s total assets, or \$50 billion. A national bank must exclude from its assets and equity all equity investments, including retained earnings, in a financial subsidiary. The assets of the subsidiary may not be consolidated with the bank’s assets. The bank must also have policies and procedures to assess financial subsidiary risk and protect the bank from such risks and potential liabilities.

The GLB Act provides that designated federal regulatory agencies, including the FDIC, the FRB, the OCC and the SEC, must publish regulations to implement certain provisions of the Act. These agencies have cooperated in the release of rules that establish minimum requirements to be followed by financial institutions for protecting the privacy of financial information provided by consumers. The FDIC’s rule requires a financial institution to (i) provide notice to customers about its privacy policies and practices, (ii) describe the conditions under which the institution may disclose nonpublic personal information about consumers to nonaffiliated third parties, and (iii) provide a method for consumers to prevent the financial institution from disclosing information to nonaffiliated third parties by “opting out” of that disclosure.

The GLB Act also includes a new section of the Federal Deposit Insurance Act governing subsidiaries of state banks that engage in “activities as principal that would only be permissible” for a national bank to conduct in a financial subsidiary. It expressly preserves the ability of a state bank to retain all existing subsidiaries. Because California permits commercial banks chartered by the state to engage in any activity permissible for national banks, HBC will be permitted to form subsidiaries to engage in the activities authorized by the GLB Act, to the same extent as a national bank. In order to form a financial subsidiary, the

bank must be well-capitalized, and the bank would be subject to the same capital deduction, risk management and affiliate transaction rules are applicable to national banks.

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

Limitations on Dividends

The Company's ability to pay cash dividends is dependent on dividends paid to it by HBC. Under California law the holders of common stock of the Company are entitled to receive dividends when and as declared by the Board of Directors, out of funds legally available therefor, subject to certain restrictions. A California corporation such as the Company may make a distribution to its shareholders if its retained earnings will equal at least the amount of the proposed distribution. California law further provides that in the event sufficient retained earnings are not available for the proposed distribution a corporation may nevertheless make a distribution to its shareholders if, after giving effect to the distribution, it meets two conditions, which generally stated are as follows: (i) the corporation's assets must equal at least 125% of its liabilities; and (ii) the corporation's current assets must equal at least its current liabilities or, if the average of the corporation's earnings before taxes on income and before interest expense for the two preceding fiscal years was less than the average of the corporation's interest expense for such fiscal years, then the corporation's current assets must equal at least 125% of its current liabilities. Most bank holding companies are unable to meet this test.

The payment of cash dividends by the Company depends on various factors, including the earnings and capital requirements of itself and its subsidiaries, and other financial conditions. The primary source of funds for payment of dividends by the Company to its shareholders will be the receipt of dividends and management fees from HBC. The Company has no present intention of paying cash dividends in the foreseeable future. The legal ability of HBC to pay dividends is subject to restrictions set forth in the California banking law and regulations of the FDIC. No assurance can be given that HBC will pay dividends at any time. For restrictions applicable to HBC, see Item 5 — "MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS — Dividends."

Safety and Soundness Standards

The federal banking agencies have adopted guidelines establishing standards for safety and soundness. The guidelines are designed to assist the federal banking agencies in identifying and addressing potential safety and soundness concerns before capital becomes impaired. The guidelines set forth operational and managerial standards relating to internal controls, information systems and internal audit systems, loan documentation, credit underwriting, interest rate exposure, earnings, asset quality, asset growth, and compensation, fees and benefits. The guidelines establish the safety and soundness standards that the agencies use to identify and address problems at insured depository institutions before capital becomes impaired. If an institution fails to comply with a safety and soundness standard, the appropriate federal banking agency may require the institution to submit a compliance plan. Failure to submit a compliance plan or to implement an accepted plan may result in enforcement action.

"Source Of Strength" Policy

According to FRB policy, bank holding companies are expected to act as a source of financial strength to each subsidiary bank and to commit resources to support each such subsidiary.

Capital Adequacy Guidelines

Federal banking agencies have adopted risk-based capital guidelines for insured banks and bank holding companies. These guidelines require a minimum risk-based capital ratio of 8%, with at least 4% in the form of “Tier 1” capital. Tier 1 capital consists of common equity, non-cumulative perpetual preferred stock, trust preferred securities, and minority interests in the equity accounts of consolidated subsidiaries and excludes goodwill. “Tier 2” capital consists of cumulative perpetual preferred stock, limited-life preferred stock, mandatory convertible securities, subordinated debt and (subject to a limit of 1.25% of risk-weighted assets) general loan loss reserves.

The guidelines make regulatory capital requirements more sensitive to the differences in risk profiles among banking institutions, take off-balance sheet items into account when assessing capital adequacy and minimize disincentives to holding liquid low-risk assets. In addition, the regulations may require some banking institutions to increase the level of their common shareholders’ equity. Banking regulators have also instituted minimum leverage ratio guidelines for financial institutions. The leverage ratio guidelines require maintenance of a minimum ratio of 3% Tier 1 capital to total assets for the most highly rated bank holding Company organizations. Institutions that are less highly rated, anticipating significant growth, or subject to other significant risks will be required to maintain capital levels ranging from 1% to 2% above the 3% minimum.

The following table presents the capital ratios of the Company computed in accordance with applicable regulatory guidelines and compared to the standards for minimum capital adequacy requirements under the FDIC’s prompt corrective action authority as of December 31, 2002:

	December 31, 2002			
	Actual		For Capital Adequacy Purposes	
	Amount	Ratio	Amount	Ratio
Total risk-based capital/risk-weighted assets	\$113,177,000	13.4%	\$67,568,000	(greater than or equal to) 8.0%
Tier 1 capital/risk-weighted assets	\$102,614,000	12.2%	\$33,645,000	(greater than or equal to) 4.0%
Tier 1 capital / average assets	\$102,614,000	10.8%	\$38,005,000	(greater than or equal to) 4.0%

Federal banking agencies, including the FRB and the FDIC, have adopted regulations implementing a system of prompt corrective action pursuant to the Federal Deposit Insurance Corporation Improvement Act of 1991 (“FDICIA”). The regulations establish five capital categories for banks based on the capital measures indicated below:

Capital Category	Total Risk-Based Capital Ratio	Tier 1 Risk-Based Capital Ratio	Tier 1 Leverage Ratio
Well capitalized	10.0%	6.0%	5.0%
Adequately capitalized	8.0%	4.0%	4.0%
Undercapitalized	less than 8.0%	less than 4.0%	less than 4.0%
Significantly undercapitalized	less than 6.0%	less than 3.0%	less than 3.0%
Critically undercapitalized ⁽¹⁾	N/A	N/A	N/A

(1) Tangible equity to total assets less than 2.0%

As of December 31, 2002, management believes the Company’s capital met all minimum regulatory requirements and that the Company’s subsidiary Banks were all considered “well capitalized” under the regulatory framework for prompt corrective action.

The regulations establish procedures for classification of financial institutions within the capital categories, filing and reviewing capital restoration plans required under the regulations and procedures for issuance of

directives by the appropriate regulatory agency, among other matters. See Item 1 — “BUSINESS — Supervision and Regulation — Prompt Corrective Action.”

The appropriate federal banking agency, after notice and an opportunity for a hearing, is authorized to treat a well capitalized, adequately capitalized or undercapitalized insured depository institution as if it had a lower capital-based classification if it is in an unsafe or unsound condition or engaging in an unsafe or unsound practice. Thus, an adequately capitalized institution can be subject to the restrictions on undercapitalized institutions (provided that a capital restoration plan cannot be required of the institution) described below and an undercapitalized institution can be subject to the restrictions applicable to significantly undercapitalized institutions described below. See Item 1 — “BUSINESS — Supervision And Regulation — Prompt Corrective Action.”

An insured depository institution cannot make a capital distribution (as broadly defined to include, among other items, dividends, redemption and other repurchases of stock), or pay management fees to any person who controls the institution, if thereafter it would be undercapitalized. The appropriate federal banking agency, however, may (after consultation with the FDIC) permit an insured depository institution to repurchase, redeem, retire or otherwise acquire its shares if such action (i) is taken in connection with the issuance of additional shares or obligations in at least an equivalent amount and (ii) will reduce the institution’s financial obligations or otherwise improve its financial condition. An undercapitalized institution is also generally prohibited from increasing its average total assets. An undercapitalized institution is also generally prohibited from making any acquisitions, establishing any branches or engaging in any new line of business except in accordance with an accepted capital restoration plan or with the approval of the FDIC. In addition, the appropriate federal banking agency is given authority with respect to any undercapitalized depository institution to take any of the actions it is required to or may take with respect to a significantly undercapitalized institution as described below if it determines “that those actions are necessary to carry out the purpose” of FDICIA.

The federal banking agencies have adopted a joint agency policy statement to provide guidance on managing interest rate risk. The statement indicated that the adequacy and effectiveness of a bank’s interest rate risk management process and the level of its interest rate exposures are critical factors in the agencies’ evaluation of the bank’s capital adequacy. If a bank has material weaknesses in its risk management process or high levels of exposure relative to its capital, the agencies will direct it to take corrective action. Such directives may include recommendations or directions to raise additional capital, strengthen management expertise, improve management information and measurement systems, reduce level of exposure or some combination of these actions.

The federal banking agencies have issued an interagency policy statement that, among other things, establishes certain benchmark ratios of loan loss reserves to certain classified assets. The benchmark set forth by such policy statement is the sum of (i) 100% of assets classified loss; (ii) 50% of assets classified doubtful; (iii) 15% of assets classified substandard; and (iv) estimated credit losses on other assets over the upcoming 12 months. This amount is neither a “floor” nor a “safe harbor” level for an institution’s allowance for loan losses.

Insurance Premiums and Assessments

Pursuant to FDICIA, the FDIC has developed a risk-based assessment system, under which the assessment rate for an insured depository institution will vary according to the level of risk incurred on its activities. An institution’s risk category is based upon whether the institution is well capitalized, adequately capitalized or less than adequately capitalized. Each insured depository institution is also to be assigned to one of the following “supervisory subgroups”: group A, B or C. Group A institutions are financially sound institutions with few minor weaknesses; Group B institutions are institutions that demonstrate weaknesses which, if not corrected, could result in significant deterioration; and Group C institutions are institutions for which there is a substantial probability that the FDIC will suffer a loss in connection with the institution unless effective action is taken to correct the areas of weakness.

The FDIC assigns each Bank Insurance Fund (BIF) member institution an annual FDIC assessment rate, summarized below (assessment figures are expressed in terms of cents per \$100 in deposits):

<u>Capital Category</u>	<u>Group A</u>	<u>Group B</u>	<u>Group C</u>
Well capitalized	0 ⁽¹⁾	3	17
Adequately capitalized	3	10	24
Undercapitalized	10	24	27

(1) Subject to a statutory minimum assessment of \$2,000 per year (which also applies to all other assessment risk classifications).

At December 31, 2002, HBC's, HBEB's, HBSV's, and BLA's assessment rates were all equivalent to that of a well capitalized, group A institution.

Pursuant to the Economic Growth and Paperwork Reduction Act of 1996 (the "Paperwork Reduction Act"), at January 1, 1997, HBC began paying, in addition to their normal deposit insurance premium as a member of the BIF, an assessment that is used toward the retirement of the Financing Corporation bonds ("FICO Bonds") issued in the 1980s to assist in the recovery of the savings and loan industry. Members of the Savings Association Insurance Fund ("SAIF"), also pay an assessment, which generally has been calculated at a higher rate than the assessment paid by banks. Under the Paperwork Reduction Act, the FDIC is not permitted to establish SAIF assessment rates that are lower than comparable BIF assessment rates. Effective January 1, 2000, the rate paid to retire the FICO Bonds became equal for members of the BIF and the SAIF. The Paperwork Reduction Act also provided for the merging of the BIF and the SAIF by January 1, 1999 provided there were no financial institutions still chartered as savings associations at that time. However, as of January 1, 2003, there were still financial institutions chartered as savings associations.

In February 2000 the FDIC announced that it was refining the system by which it assesses the risks that are presented to the deposit insurance fund by certain financial institutions. The refinements are intended to identify institutions with a typically high-risk profiles from among those institutions in the best-rated premium category, and to determine whether there are unresolved supervisory concerns regarding the risk-management practices of those institutions. The FDIC is concerned about institutions that exhibit characteristics such as rapid asset growth (especially when concentrated in potentially risky, high-yielding lending areas), significant concentrations in high-risk assets, and recent changes in business mix. The FDIC has noted that although such institutions may be well-capitalized and exhibit good earnings when the economy is strong, they often experience deteriorating financial conditions when economic conditions are less favorable. As a result, institutions whose practices are determined to exhibit risky traits under the refined risk assessment system will be assessed higher insurance premiums. These rules are not expected to have a significant impact on HBC.

Prompt Corrective Action

The FDIC has authority: (1) to request that an institution's regulatory agency take enforcement action against it based upon an examination by the FDIC or the agency, (2) if no action is taken within 60 days and the FDIC determines that the institution is in an unsafe or unsound condition or that failure to take the action will result in continuance of unsafe or unsound practices, to order the action against the institution, and (3) to exercise this enforcement authority under "exigent circumstances" merely upon notification to the institution's appropriate regulatory agency. This authority gives the FDIC the same enforcement powers with respect to any institution and its subsidiaries and affiliates as such institution's appropriate regulatory agency has with respect to those entities.

An undercapitalized institution is required to submit an acceptable capital restoration plan to its appropriate federal banking agency. The plan must specify (i) the steps the institution will take to become adequately capitalized, (ii) the capital levels to be attained each year, (iii) how the institution will comply with any regulatory sanctions then in effect against the institution, and (iv) the types and levels of activities in which the institution will engage. The banking agency may not accept a capital restoration plan unless the agency determines, among other things, that the plan "is based on realistic assumptions, and is likely to

succeed in restoring the institution's capital" and "would not appreciably increase the risk . . . to which the institution is exposed." A requisite element of an acceptable capital restoration plan for an undercapitalized institution is a guaranty by its parent holding Company that the institution will comply with such capital restoration plan. Liability with respect to this guaranty is limited to the lesser of (i) five percent of the institution's assets at the time when it became undercapitalized and (ii) the amount necessary to bring the institution into capital compliance with "all capital standards applicable to [it]" as of the time when the institution fails to comply with the plan. The guaranty liability is limited to companies controlling the undercapitalized institution and does not affect other affiliates. In the event of a bank holding Company's bankruptcy, any commitment by the bank holding Company to a federal bank regulatory agency to maintain the capital of a subsidiary bank will be assumed by the bankruptcy trustee and entitled to priority of payment over the claims of other creditors, including the holders of the Company's long-term debt.

FDICIA provides that the appropriate federal regulatory agency must require an insured depository institution that (i) is significantly undercapitalized or (ii) is undercapitalized and either fails to submit an acceptable capital restoration plan within the time period allowed by regulation or fails in any material respect to implement a capital restoration plan accepted by the appropriate federal banking agency to take one or more of the following actions: (i) sell enough shares, including voting shares, to become adequately capitalized; (ii) merge with (or be sold to) another institution (or holding Company), but only if grounds exist for appointing a conservator or receiver; (iii) restrict certain transactions with banking affiliates as if the "sister bank" exception to the requirements of Section 23A of the Federal Reserve Act did not exist; (iv) otherwise restrict transactions with bank or non-bank affiliates; (v) restrict interest rates that the institution pays on deposits to "prevailing rates" in the institution's "region"; (vi) restrict asset growth or reduce total assets; (vii) alter, reduce or terminate activities; (viii) hold a new election of directors; (ix) dismiss any director or senior executive officer who held office for more than 180 days immediately before the institution became undercapitalized, provided that in requiring dismissal of a director or senior executive officer, the agency must comply with certain procedural requirements, including the opportunity for an appeal in which the director or officer will have the burden of proving his or her value to the institution; (x) employ "qualified" senior executive officers; (xi) cease accepting deposits from correspondent depository institutions; (xii) divest certain non-depository affiliates which pose a danger to the institution; (xiii) be divested by a parent holding Company; and (xiv) take any other action which the agency determines would better carry out the purposes of the prompt corrective action provisions.

In addition to the foregoing sanctions, without the prior approval of the appropriate federal banking agency, a significantly undercapitalized institution may not pay any bonus to any senior executive officer or increase the rate of compensation for such an officer without regulatory approval. Furthermore, in the case of an undercapitalized institution that has failed to submit or implement an acceptable capital restoration plan, the appropriate federal banking agency cannot approve any such bonus.

Not later than 90 days after an institution becomes critically undercapitalized, the appropriate federal banking agency for the institution must appoint a receiver or a conservator, unless the agency, with the concurrence of the FDIC, determines that the purposes of the prompt corrective action provisions would be better served by another course of action. Any alternative determination must be documented by the agency and reassessed on a periodic basis. Notwithstanding the foregoing, a receiver must be appointed after 270 days unless the FDIC determines that the institution has a positive net worth, is in compliance with a capital plan, is profitable or has a sustainable upward trend in earnings and is reducing its ratio of non-performing loans to total loans and the head of the appropriate federal banking agency and the chairperson of the FDIC certify that the institution is viable and not expected to fail.

The FDIC is required, by regulation or order, to restrict the activities of such critically undercapitalized institutions. The restrictions must include prohibitions on the institution's doing any of the following without prior FDIC approval: entering into any material transactions not in the usual course of business; extending credit for any highly leveraged transaction; engaging in any "covered transaction" (as defined in Section 23A of the Federal Reserve Act) with an affiliate; paying "excessive compensation or bonuses"; and paying interest on "new or renewed liabilities" that would increase the institution's average cost of funds to a level significantly exceeding prevailing rates in the market.

Brokered Deposits

A bank cannot accept brokered deposits (defined to include payment of an interest rate more than 75 basis points above prevailing rates) unless (i) it is well capitalized or (ii) it is adequately capitalized and receives a waiver from the FDIC. A bank that cannot receive brokered deposits also cannot offer “pass-through” insurance on certain employee benefit accounts unless certain specified procedures are followed. In addition, a bank that is “adequately capitalized” may not pay an interest rate on any deposits in excess of 75 basis points over certain prevailing market rates. There are no such restrictions on a bank that is “well capitalized.”

Federal Reserve Borrowings

The FRB may not make advances to an undercapitalized institution for more than 60 days in any 120-day period without a viability certification by a federal banking agency or by the Chairman of the FRB after an examination by the FRB. If an institution is deemed critically undercapitalized, an extension of FRB credit cannot continue for more than five days without demand for payment unless the FRB is willing to accept responsibility for any resulting loss to the FDIC. As a practical matter, this provision is likely to mean that FRB credit will not be extended beyond the limitations in this provision.

Potential Enforcement Actions; Supervisory Agreements

Banks and their institution-affiliated parties may be subject to potential enforcement actions by the FRB, the FDIC or the Office of the Comptroller of the Currency (OCC) for unsafe or unsound practices in conducting their businesses, or for violations of any law, rule or regulation or provision, any consent order with any agency, any condition imposed in writing by the agency or any written agreement with the agency. Enforcement actions may include the imposition of a conservator or receiver, cease-and-desist orders and written agreements, the termination of insurance of deposits, the imposition of civil money penalties and removal and prohibition orders against institution-affiliated parties.

Interstate Banking

Interstate Banking and Branching. The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (Riegle-Neal Act) authorizes interstate banking and interstate branching, subject to certain state options.

- Interstate acquisition of banks became permissible in all states on and after September 29, 1995; state law cannot vary this rule. However, states may continue to prohibit acquisition of banks that have been in existence less than five years and interstate chartering of new banks.
- Interstate mergers of affiliated or unaffiliated banks became permitted after June 1, 1997, unless a state adopted legislation before June 1, 1997 to “opt out” of interstate merger authority, provided any limitations do not discriminate against out-of-state banks. Only Texas opted out.
- Interstate acquisitions of branches are permitted to a bank only if the law of the state where the branch is located expressly permits interstate acquisition of a branch without acquiring the entire bank.
- Interstate de novo branching is permitted to a bank only if a state has adopted legislation to “opt in” to interstate de novo branching authority.

Limitations on Concentrations. An interstate banking application may not be approved if the applicant and its depository institution affiliates would control more than 10% of insured deposits nationwide or more than 30% of insured deposits in the state in which the bank to be acquired is located. These limits do not apply to mergers solely between affiliates. States may waive the 30% cap on a nondiscriminatory basis. Nondiscriminatory state caps on deposit market share of a depository institution and its affiliates are not affected by the regulation.

Agency Authority. A bank subsidiary of a bank holding Company can be authorized to receive deposits, renew time deposits, close loans, service loans and receive payments on loans as an agent for a depository

institution affiliate without being deemed a branch of the affiliate. Banks are not permitted to engage, as agent for an affiliate, in any activity as agent that it could not conduct as a principal, or to have an affiliate, as its agent, conduct any activity that it could not conduct directly, under federal or state law.

Host State Regulation. The Riegle-Neal Amendments Act of 1997 amended federal law to provide that branches of state banks that operate in other states will be governed in most cases by the laws of the home state, rather than the laws of the host state. Exceptions are that a host state may apply its own laws of community reinvestment, consumer protection, fair lending and interstate branching. Host states cannot supplement or restrict powers granted by a bank's home state. The amendment will assure state-chartered banks with interstate branches uniform treatment in most areas of their operation.

Community Reinvestment Act. Community Reinvestment Act (CRA) evaluations are required for each state in which an interstate bank has a branch. Interstate banks are prohibited from using out-of-state branches "primarily for the purpose of deposit production." Federal banking agencies have adopted regulations to ensure that interstate branches are being operated with a view to the needs of the host communities.

Foreign Banks. Foreign banks are able to branch to the same extent as U.S. domestic banks. Interstate branches acquired by foreign banks are subject to the CRA to the extent the acquired branch was subject to the CRA before the acquisition.

California Law. California has enacted state legislation in accordance with authority under the Riegle-Neal Act. This state law permits banks headquartered outside California to acquire or merge with California banks that have been in existence for at least five years, and thereby establish one or more California branch offices. An out-of-state bank may not enter California by acquiring one or more branches of a California bank or other operations constituting less than the whole bank. The law authorizes waiver of the 30% limit on state-wide market share for deposits as permitted by the Riegle-Neal Act. The law also authorizes California state-licensed banks to conduct certain banking activities (including receipt of deposits and loan payments and conducting loan closings) on an agency basis on behalf of out-of-state banks and to have out-of-state banks conduct similar agency activities on their behalf.

Tie-in Arrangements and Transactions with Affiliated Persons

A bank is prohibited from certain tie-in arrangements in connection with any extension of credit, sale or lease of property or furnishing of services. For example, with certain exceptions, a bank may not condition an extension of credit on a promise by its customer to obtain other services provided by it, its holding Company or other subsidiaries (if any), or on a promise by its customer not to obtain other services from a competitor.

Directors, officers and principal shareholders of the Company, and the companies with which they are associated, may conduct banking transactions with the Company in the ordinary course of business. Any loans and commitments to loans included in such transactions must be made in accordance with applicable law, on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with other persons of similar creditworthiness, and on terms not involving more than the normal risk of collectibility or presenting other unfavorable features.

Community Reinvestment Act

Pursuant to the Community Reinvestment Act of 1977, the federal regulatory agencies that oversee the banking industry are required to use their authority to encourage financial institutions to help meet the credit needs of the local communities in which such institutions are chartered, consistent with safe and sound banking practices.

When conducting an examination of a financial institution such as HBC, the agencies assess the institution's record of meeting the credit needs of its entire community, including low- and moderate-income neighborhoods. This record is taken into account in an agency's evaluation of an application for creation or relocation of domestic branches or for merger with another institution. Failure to address the credit needs of a

bank's community may also result in the imposition of certain other regulatory sanctions, including a requirement that corrective action be taken.

The federal banking agencies determine a bank's CRA rating by evaluating its performance on lending, service, and investment tests, with the lending test as the most important. The tests are to be applied in an "assessment context" that is developed by the agency for a particular institution. The assessment context takes into account demographic data about the community, the community's characteristics and needs, the institution's capacities and constraints, the institution's product offerings and business strategy, the institution's prior performance, and data on similarly situated lenders. Since the assessment context is developed by the regulatory agencies, a particular bank will not know until it is examined whether its CRA programs and efforts have been sufficient.

Larger institutions are required to compile and report certain data on their lending activities in order to measure performance. Some of this data is also required under other laws, such as the Equal Credit Opportunity Act. Small institutions (those institutions with less than \$250 million in assets) are now being examined on a "streamlined assessment method." The streamlined method focuses on the institution's loan to deposit ratio, degree of local lending, record of lending to borrowers and neighborhoods of differing income levels, and record of responding to complaints. Large and small institutions have the option of being evaluated for CRA purposes in relation to their own pre-approved strategic plan. Such a strategic plan must be submitted to the institution's regulator three months before its effective date and be published for public comment.

Environmental Regulation

Federal, state, and local regulations regarding the discharge of materials into the environment may have an impact on the Company. Under federal law, liability for environmental damage and the cost of cleanup may be imposed on any person or entity who is an owner or operator of contaminated property. State law provisions impose substantially similar requirements. Both federal and state laws provide generally that a lender who is not actively involved in contaminating a property will not be liable to clean up the property, even if the lender has a security interest in the property or becomes an owner of the property through foreclosure, provided certain conditions are observed.

The Economic Growth Act includes protection for lenders from liability under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980. The Economic Growth Act specifies the actions a lender may take with respect to lending and foreclosure activities without incurring environmental cleanup liability or responsibility. Typical contractual provisions regarding environmental issues in the loan documentation and due diligence inspections will not lead to lender liability for cleanup, and a lender may foreclose on contaminated property, so long as it merely maintains the property and moves to divest it at the earliest possible time.

Under California law, a lender generally will not be liable to the State for the cost associated with cleaning up contaminated property unless the lender realized some benefit from the property, failed to divest the property promptly, caused or contributed to the release of the hazardous materials, or made the loan primarily for purposes of investing in the property.

The extent of the protection provided by both the federal and state lender protection statutes depend on their interpretation by administrative agencies and courts. The Company cannot predict whether it will be adequately protected for the types of loans made by it. In addition, the Company is still subject to the risks that a borrower's financial position will be impaired by liability under the environmental laws and that property securing a loan made by the Company may be environmentally impaired and not provide adequate security for the Company. The Company attempts to protect its position against environmental risks by performing prudent due diligence. Environmental questionnaires and information on the use of toxic substances are requested as part of its underwriting procedures. The Company lends based on its evaluation of the collateral, net worth of the borrower, and the borrower's capacity for unforeseen business interruptions or risks.

Limitation on Activities

FDICIA prohibits state chartered-banks and their subsidiaries from engaging, as principal, in activities not permissible by national banks and their subsidiaries, unless the bank's primary federal regulator determines the activity poses no significant risk to the BIF and the state bank is and continues to be adequately capitalized. Similarly, state bank subsidiaries may not engage, as principal, in activities impermissible by subsidiaries of national banks. This prohibition extends to acquiring or retaining any investment, including those that would otherwise be permissible under California law.

The State Bank Parity Act, eliminates certain disparities between California state chartered banks and federally chartered national banks by authorizing the Commissioner to address such disparities through a streamlined rulemaking process. The Commissioner has taken action pursuant to the Parity Act to authorize, among other matters, previously impermissible share repurchases by state banks, subject to the prior approval of the Commissioner.

In November 1996, the OCC issued final regulations permitting national banks to engage in a wider range of activities through subsidiaries. "Eligible institutions" (those national banks that are well-capitalized, have a high overall rating and a satisfactory CRA rating, and are not subject to an enforcement order) may engage in activities related to banking through operating subsidiaries after going through a new expedited application process. In addition, the new regulations include a provision whereby a national bank may apply to the OCC to engage in an activity through a subsidiary in which the bank itself may not engage. In determining whether to permit the subsidiary to engage in the activity, the OCC will evaluate why the bank itself is not permitted to engage in the activity and whether a Congressional purpose will be frustrated if the OCC permits the subsidiary to engage in the activity. The State Bank Parity Act may permit state-licensed banks to engage in similar new activities, subject to the discretion of the Commissioner.

State Bank Sales of Non-Deposit Investment and Insurance Products

Securities activities of state non-member banks, as well as the activities of their subsidiaries and affiliates, are governed by the GLB Act and by guidelines and regulations issued by the securities and financial institution regulatory agencies. These agencies have taken the position that bank sales of alternative investment products, such as mutual funds and annuities, raise substantial bank safety and soundness concerns involving consumer confusion over the nature of the products offered, as well as the potential for mismanagement of sales programs which could expose a bank to liability under the antifraud provisions of federal securities laws.

Accordingly, the agencies have issued guidelines that require, among other things, the establishment of a compliance and audit program to monitor a bank's mutual funds sales activities and its compliance with applicable federal securities laws; the provision of full disclosures to customers about the risks of such investments, including the possible loss of the customer's principal investment; and the conduct of securities activities of bank subsidiaries or affiliates in separate and distinct locations. In addition, the guidelines prohibit bank employees involved in deposit-taking activities from selling investment products or giving investment advice. Banks are also required to establish a qualitative standard for the selection and marketing of the investments offered by the bank, and to maintain appropriate documentation regarding the suitability of investments recommended to bank customers.

California state-licensed banks have authority to engage in the insurance business as an agent or broker, but not as an insurance underwriter.

Change in Senior Executives or Board Members

Certain banks and bank holding companies are required to file a notice with their primary regulator prior to (i) adding or replacing a member of the board of directors, or (ii) the employment of or a change in the responsibilities of a senior executive officer. Notice is required if the bank or holding company is failing to meet its minimum capital standards or is otherwise in a "troubled condition", as defined in FDIC regulations,

has undergone a change in control within the past two years, or has received its bank charter within the past two years.

Impact of Economic Conditions and Monetary Policies

The earnings and growth of the Company will be affected by general economic conditions, both domestic and international, and by the monetary and fiscal policies of the United States Government and its agencies, particularly the FRB. One function of the FRB is to regulate the national supply of bank credit in order to mitigate recessionary and inflationary pressures. Among the instruments of monetary policy used to implement those objectives are open market transactions in United States Government securities, changes in the discount rate on member bank borrowings and changes in reserve requirements held by depository institutions. The monetary policies of the FRB have had a significant effect on the operating results of commercial banks in the past and are expected to continue to do so in the future. However, the effect, if any, of such policies on the future business and earnings of the Company cannot be accurately predicted.

Cross-Institution Assessments

Any insured depository institution owned by the Company can be assessed for losses incurred by the FDIC in connection with assistance provided to, or the failure of, any other depository institution owned by the Company.

Audit Requirements

Like all California state-chartered commercial banks, HBC is required to have an annual independent audit and to prepare all financial statements in accordance with generally accepted accounting principles. HBC is also required to have an independent audit committee comprised entirely of outside directors. Under National Association of Securities Dealers (NASD) on-time certifications, the Company has certified that the audit committee has adopted a formal written charter and meets the requisite number of directors, independence and qualification standards. The Company's stock is listed on Nasdaq.

Other Consumer Protection Laws and Regulations

The bank regulatory agencies closely monitor an institution's compliance with consumer protection laws and regulations. The examination and enforcement activities conducted by these agencies are intense, and banks have been advised to focus on compliance with consumer protection laws and their implementing regulations. The federal Interagency Task Force on Fair Lending has issued a policy statement on discrimination in home mortgage lending which describes three methods that federal agencies will use to prove discrimination: overt evidence of discrimination, evidence of disparate treatment, and evidence of disparate impact. In addition to CRA and fair lending requirements, HBC is subject to numerous other federal consumer protection statutes and regulations. Due to heightened regulatory concern related to compliance with consumer protection laws and regulations generally, HBC may incur additional compliance costs or be required to expend additional funds for investments in the local communities it serves.

USA PATRIOT Act

On October 26, 2001, President Bush signed into law the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the "USA PATRIOT Act").

Part of the USA Patriot Act is the International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001 ("IMLAFATA").

IMLAFATA authorizes the Secretary of the Treasury, in consultation with the heads of other government agencies, to adopt special measures applicable to banks, bank holding companies, and/or other financial institutions. These measures may include enhanced recordkeeping and reporting requirements for certain financial transactions that are of primary money laundering concern, due diligence requirements

concerning the beneficial ownership of certain types of accounts, and restrictions or prohibitions on certain types of accounts with foreign financial institutions.

Among its other provisions, IMLAFATA requires each financial institution to: (i) establish an anti-money laundering program; (ii) establish due diligence policies, procedures and controls with respect to its private banking accounts and correspondent banking accounts involving foreign individuals and certain foreign banks; and (iii) avoid establishing, maintaining, administering, or managing correspondent accounts in the United States for, or on behalf of, a foreign bank that does not have a physical presence in any country. In addition, IMLAFATA contains a provision encouraging cooperation among financial institutions, regulatory authorities and law enforcement authorities with respect to individuals, entities and organizations engaged in, or reasonably suspected of engaging in, terrorist acts or money laundering activities. IMLAFATA expands the circumstances under which funds in a bank account may be forfeited and requires covered financial institutions to respond under certain circumstances to requests for information from federal banking agencies within 120 hours. IMLAFATA also amends the Bank Holding Company Act and the Bank Merger Act to require the federal banking agencies to consider the effectiveness of a financial institution's anti-money laundering activities when reviewing an application under these acts.

Regulations adopted pursuant to IMLAFATA implement minimum standards to verify customer identity, to encourage cooperation among financial institutions, federal banking agencies, and law enforcement authorities regarding possible money laundering or terrorist activities, to prohibit the anonymous use of "concentration accounts," and to require all covered financial institutions to have in place a Bank Secrecy Act compliance program.

The Company is establishing policies and procedures to ensure compliance with the IMLAFATA. As of the date of this filing, the Company has not determined the impact that IMLAFATA will have on the Company's operations.

Regulation W

On December 12, 2002, the FRB adopted Regulation W, the rule that comprehensively implements sections 23A and 23B of the Federal Reserve Act. The rule is effective April 1, 2003.

Sections 23A and 23B and Regulation W limit the risks to a bank from transactions between the bank and its affiliates and limit the ability of a bank to transfer to its affiliates the benefits arising from the bank's access to insured deposits, the payment system and the discount window and other benefits of the FRB. The statute and rule impose quantitative and qualitative limits on the ability of a bank to extend credit to, or engage in certain other transactions with, an affiliate (and a nonaffiliate if an affiliate benefits from the transaction). However, certain transactions that generally do not expose a bank to undue risk or abuse the safety net are exempted from coverage under Regulation W.

Historically, a subsidiary of a bank was not considered an affiliate for purposes of Sections 23A and 23B, since their activities were limited to activities permissible for the bank itself. The GLB Act authorized "financial subsidiaries" that may engage in activities not permissible for a bank. These financial subsidiaries are now considered affiliates. Certain transactions between a financial subsidiary and another affiliate of a bank are also covered by sections 23A and 23B under Regulation W.

Regulation W has certain exemptions, including:

- For state-chartered banks, an exemption for subsidiaries lawfully conducting nonbank activities before issuance of the final rule.
- An exemption for extensions of credit by a bank under a general purpose credit card where the borrower uses the credit to purchase goods or services from an affiliate of the bank, so long as less than 25 percent of the aggregate amount of purchases with the card are purchases from an affiliate of the bank (a bank that does not have nonfinancial affiliates is exempt from the 25 percent test).
- An exemption for loans by a bank to a third party secured by securities issued by a mutual fund affiliate of the bank (subject to a number of conditions).

- An exemption that would permit a banking organization to engage more expeditiously in internal reorganization transactions involving a bank's purchase of assets from an affiliate (subject to a number of conditions).

The final rule contains new valuation rules for a bank's investments in, and acquisitions of, affiliates.

The FRB expects examiners and other supervisory staff to review intercompany transactions closely for compliance with the statutes and Regulation W and to resolve any violations or potential violations quickly.

Sarbanes-Oxley Act of 2002

On July 30, 2002, the President signed into law the Sarbanes-Oxley Act of 2002 (the "Act"), which implemented legislative reforms intended to address corporate and accounting fraud. In addition to the establishment of a new accounting oversight board that will enforce auditing, quality control and independence standards and will be funded by fees from all publicly traded companies, the Act places certain restrictions on the scope of services that may be provided by accounting firms to their public company audit clients. All services being provided to a public company audit client will require preapproval by the company's audit committee. In addition, the Act makes certain changes to the requirements for partner rotation after a period of time. The Act requires chief executive officers and chief financial officers, or their equivalent, to certify to the accuracy of periodic reports filed with the SEC, subject to civil and criminal penalties if they knowingly or willingly violate this certification requirement. In addition, under the Act, counsel will be required to report evidence of a material violation of the securities laws or a breach of fiduciary duty by a company to its chief executive officer or its chief legal officer, and, if such officer does not appropriately respond, to report such evidence to the audit committee or other similar committee of the board of directors or the board itself.

Under the Act, longer prison terms will apply to corporate executives who violate federal securities laws; the period during which certain types of suits can be brought against a company or its officers is extended; and bonuses issued to top executives prior to restatement of a company's financial statements are now subject to disgorgement if such restatement was due to corporate misconduct. Executives are also prohibited from insider trading during retirement plan "blackout" periods, and loans to company executives (other than loans by financial institutions permitted by federal rules and regulations) are restricted. In addition, a provision directs that civil penalties levied by the SEC as a result of any judicial or administrative action under the Act be deposited to a fund for the benefit of harmed investors. The legislation accelerates the time frame for disclosures by public companies, as they must immediately disclose any material changes in their financial condition or operations. Directors and executive officers must also provide information for most changes in ownership in a company's securities generally within two business days of the change.

The Act also increases responsibilities and codifies certain requirements relating to audit committees of public companies and how they interact with the company's "registered public accounting firm." Audit Committee members must be independent and are absolutely barred from accepting consulting, advisory or other compensatory fees from the issuer. In addition, companies must disclose whether at least one member of the committee is an "audit committee financial expert" (as defined by the SEC) and if not, why not. A company's registered public accounting firm will be prohibited from performing audit services for a company if the company's chief executive officer, chief financial officer, comptroller, chief accounting officer or any person serving in equivalent positions had been employed by the auditor and participated in the company's audit during the year preceding the audit initiation date. The Act also prohibits any officer or director of a company or any other person acting under their direction from taking any action to fraudulently influence, coerce, manipulate or mislead any independent accountant engaged in the audit of the company's financial statements for the purpose of rendering the financial statements materially misleading. The Act also requires the SEC to prescribe rules requiring inclusion of any internal control report and assessment by management in the annual report to shareholders. The Act will require the company's registered public accounting firm that issues the audit report to attest to and report on management's assessment of the company's internal controls.

Although the Company anticipates that it will incur additional expense in complying with the provisions of the Act, management does not expect that compliance will have a material impact on the Company's financial condition or results of operations.

Other Pending and Proposed Legislation

Other legislative and regulatory initiatives which could affect the Company, HBC and the banking industry in general are pending, and additional initiatives may be proposed or introduced, before the United States Congress, the California legislature and other governmental bodies in the future. For example, from time to time consumer legislation has been proposed in Congress which would require banks to offer basic, low-cost financial services to meet minimum client needs. In addition, the various banking regulatory agencies often adopt new rules and regulations to implement and enforce existing legislation. It cannot be predicted whether, or in what form, any such legislation or regulations may be enacted or the extent to which the business of the Company and HBC would be affected thereby.

Employees

At December 31, 2002, the Company had 214 full-time employees. The Company's employees are not represented by any union or collective bargaining agreement and the Company believes its employee relations are satisfactory.

Factors That May Affect Future Results of Operations

In addition to the other information contained financial condition in this report, the following risks may affect the Company. If any of these risks occurs, our business, financial condition or operating results could be adversely affected.

Changes in market interest rates may adversely affect the Company's performance

The Company's earnings are impacted by changing interest rates. Changes in interest rates impact the demand for new loans, the credit profile of existing loans, the rates received on loans and securities and rates paid on deposits and securities and borrowings. The Board of Governors of the Federal Reserve System reduced the short-term interest rates 475 basis points during 2001 and another 50 basis points in November 2002. Any further reductions will continue to have a negative effect on the Company's net interest margin and net interest income.

Business focus and economic conditions in the San Francisco Bay Area could adversely affect the Company's operations

All of the Company's operations and vast majority of its customers are located in the Bay Area of California. A continued deterioration in economic and business conditions in the Bay Area, particularly in the technology and real estate industries on which these areas depend, could have a material adverse impact on the quality of the Company's loan portfolio and the demand for the Company's products and services, which in turn may have a material adverse effect on the Company's results of operations. A downturn in the national economy might further exacerbate local economic conditions.

The banking and financial services business in California generally, and in the Company's market areas specifically, is highly competitive. The increasingly competitive environment is a result primarily of changes in regulation, changes in technology and product delivery systems, and the consolidation among financial service providers. The Company competes for loans, deposits and customers for financial services with other commercial banks, savings and loan associations, securities and brokerage companies, mortgage companies, insurance companies, finance companies, money market funds, credit unions, and other non-bank financial service providers. Many of these competitors are much larger in total assets and capitalization, have greater access to capital markets and offer a broader array of financial services than the Company. In order to compete with the other financial service providers, the Company principally relies upon local promotional activities, personal relationships established by officers, directors, and employees with its customers, and specialized services tailored to meet its customers' needs. In those instances where the Company is unable to accommodate a customer's needs, the Company seeks to arrange for such loans on a participation basis with other financial institutions or to have those services provided in whole or in part by its correspondent banks.

Both residential and commercial real estate in the Bay Area will continue to be under pressure because of the region's heavy dependence on technology. Job and spending cuts have been extensive in the Bay Area's high-tech industries, from dot-coms to the semiconductor industry. Many of the Bay Area's service industries are also severely affected by the troubled tech sector. The drop in job and income growth has had an impact on the real estate market. Further deterioration in the Bay Area job market will tend to adversely affect the quality of the Company's loan portfolio.

Item 2 Properties

The main and executive offices of the Company and the offices of HBC, are located at 150 Almaden Boulevard in San Jose, California 95113, and at 100 Park Center Plaza, Suite 300, also in San Jose, California 95113. HBEB, a division of HBC, is located at 3077 Stevenson Boulevard in Fremont, California 94538, with a branch office located at 310 Hartz Road in Danville, California 94526. HBSV, also a division of HBC, is located at 18625 Sutter Boulevard in Morgan Hill, California 95037, with a branch office at 737 First Street in Gilroy, California 95020. BLA, another division of HBC, is located at 4546 El Camino Real in Los Altos, California 94022, with branch offices located at 369 S. San Antonio Road in Los Altos, California 94022, and at 175 E. El Camino Real in Mountain View, California 94040.

HBC

The main office of HBC is located at 150 Almaden Boulevard in San Jose, California and is subleased under a non-cancelable operating lease dated February 12, 1996 with a non-affiliated third party. The primary operating area consists of approximately 13,511 square feet of Class-A office space in a 15-story building in downtown San Jose, and covers the entire usable ground floor and a portion of the second floor. The sublease arrangement for the primary operating area is a "partial gross lease" for 15 years commencing June 8, 1996 and expiring on February 28, 2010. The current monthly rent payment for this space is \$25,535 and is subject to change in 2006 based on fair rental value at that time. The Company has reserved the right to terminate the sublease in 2006, subject to the terms and conditions established for early termination.

In January of 1997, The Company leased approximately 1,255 square feet of office space located next to the primary operating area located at 150 Almaden Boulevard in San Jose, California for meetings, staff training and marketing events. The current monthly rent payment for this space is \$3,137 and is subject to annual increases of 3% until the lease expires on February 28, 2010.

In August of 1997, The Company subleased approximately 2,175 square feet of office space located on the second floor at 150 Almaden Boulevard in San Jose, California. The current monthly rent payment for this space is \$4,785 and is subject to change in 2006 based on fair rental value at that time. The sublease expires on February 28, 2010, however The Company has reserved the right to terminate the sublease in 2006, subject to the terms and conditions established for early termination.

In June of 1998, The Company leased approximately 5,623 square feet of office space located at 100 Park Center Plaza in San Jose, California. The current monthly rent payment for this space is \$12,651 until the lease expires on May 31, 2003. The Company has reserved the right to extend the lease for a single additional period of (3) three years.

In April of 2000, The Company leased approximately 12,824 square feet of office space located on the third floor at 150 Almaden Boulevard in San Jose, California. The current monthly rent payment for this space is \$46,243 and is subject to annual increases of 3% until the lease expires on February 28, 2010.

In May of 2002, The Company subleased approximately 6,731 square feet of office space located on the second floor at 150 Almaden Boulevard in San Jose, California. The current monthly rent payment for this space is \$14,808 and is subject to change in 2006 based fair rental value at that time. The sublease expires on February 28, 2010, however The Company has reserved the right to terminate the sublease in 2006, subject to the terms and conditions established for early termination.

HBC — Loan Production Offices

In August of 2000, The Company leased space for a loan production office located at 740 Front Street in Santa Cruz, California 95060. The lease covers approximately 2,176 square feet of office space and expires on July 31, 2005. The current monthly rent payment for this space is \$4,379 and is subject to annual increases based on the Consumer Price Index of the Bureau of Labor Statistics as defined in the lease agreement.

In April of 2002, The Company renewed its lease for a loan production office located at 23 E. Beach Street in Watsonville, California 95076. The lease covers approximately 147 square feet of office space and expires on April 30, 2003. The current monthly rent payment for this space is \$230.

In July of 2002, The Company leased space for (2) loan production offices located at 450 North Brand Boulevard in Glendale, California 91203. Each office is leased under a separate lease agreement, each consisting of approximately 132 square feet of office space. Both leases expire on June 30, 2003, however The Company has reserved the right to extend each lease for multiple additional periods of (1) year each. The current monthly rent payment for each office is \$1,435.

In December of 2002, The Company renewed its lease for a loan production office located at 8788 Elk Grove Boulevard in Elk Grove, California 95624. The lease consists of approximately 224 square feet of office space and expires on December 1, 2003, however The Company has reserved the right to extend the lease for a single additional period of (1) one year. The current monthly rent payment for this space is \$619.

In February of 2003, The Company renewed its lease for a loan production office located at 285 W. Shaw Avenue in Fresno, California 93720. The lease consists of approximately 336 square feet and expires on February 29, 2004. The current monthly rent payment for this space is \$456.80.

HBEB

In November of 1997, HBEB leased approximately 6,590 square feet of space for its primary office in a stand alone office building located at 3077 Stevenson Boulevard in Fremont, California. The current monthly rent payment for this space is \$15,421 and is subject to annual increases of 4% until the lease expires on October 24, 2007. HBEB has reserved the right to extend the term of the lease for (2) two successive periods of (5) five years.

In September of 1999, HBEB subleased an additional 2,700 square feet of space for a branch office in a one-story multi-tenant building located at 310 Hartz Avenue in Danville, California. The current monthly rent payment for this space is \$7,902, subject to annual increases of 4% until the lease expires on December 31, 2007.

HBSV

In March of 1999, HBSV leased approximately 7,260 square feet of space for its primary office in a one-story multi-tenant office building located at 18625 Sutter Boulevard in Morgan Hill, California. The current monthly rent payment is \$11,676 and is subject to adjustments every 36 months based on the Consumer Price Index of the Labor of Statistics as defined in the lease agreement, until the lease expires on October 31, 2014.

In January of 2001, HBSV leased an additional 2,200 square feet of space for a branch office in a one-story multi-tenant shopping center located at 737 First Street in Gilroy, California. The current monthly rent payment is \$3,244 and is subject to change annually based on the Consumer Price Index of the Bureau of Labor Statistics as defined in the lease agreement. The lease expires on December 31, 2006, however Heritage has reserved the right to extend the term of the lease for an additional period of (5) five years.

BLA

In February of 1995, BLA leased approximately 7,889 square feet of space for its primary office in a two-story multi-tenant shopping center located at 4546 El Camino Real in Los Altos, California. In October of 2001, the lease was amended to return 795 square feet to the Landlord, leaving 7,094 square feet remaining. The current monthly rent payment for this space is \$13,735 and is subject to annual increases based on the Consumer Price Index of the Bureau of Labor Statistics as defined in the lease agreement. The lease expires on September 30, 2008, however BLA has reserved the right to extend the term of the lease for an additional period of (5) five years.

In January of 1998, BLA lease an additional 4,840 square feet of space for a branch office in a multi-tenant shopping center located at 175 E. El Camino Real in Mountain View, California. The current monthly rent payment for this space is \$12,334 and is subject to annual increases based on the Consumer Price Index of the Bureau of Labor Statistics as defined in the lease agreement. The lease expires on January 31, 2008, however BLA has reserved the right to extend the lease period (2) two times by periods of (5) five years each.

In September of 1998, BLA leased an additional 3,471 square feet of space for a branch office in a one-story stand-alone office building located at 369 S. San Antonio Road in Los Altos, California. The current monthly rent payment for this space is \$14,212 and is subject to annual increases of 4% until the lease expires on September 30, 2008. BLA has reserved the right to extend the term of the lease (2) two times for periods of (5) years each.

For additional information on operating leases and rent expense, refer to Note 11 of the Company's Consolidated Financial Statements, beginning on page 75 of this Report on Form 10-K.

Item 3 *Legal Proceedings*

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

Item 4 *Submission of Matters to a Vote of Security Holders*

There was no submission of matters to a vote of security holders during the fourth quarter of the year ended December 31, 2002.

PART II

Item 5 *Market for Registrant's Common Equity and Related Stockholder Matters*

The Company's Common Stock is listed on the Nasdaq National Market under the symbol "HTBK." Everen Securities, Hoefer & Arnett, Incorporated, Sutro & Co., Incorporated and Van Kasper & Company have acted as market makers for the Common Stock. These market makers have committed to make a market for the Company's Common Stock, although they may discontinue making a market at any time. No assurance can be given that an active trading market will be sustained for the Common Stock at any time in the future.

The information in the following table for 2002 and 2001 indicates the high and low bid prices for the Common Stock, based upon information provided by the Nasdaq National Market. These quotations reflect

inter-dealer prices, without retail mark-up, mark-down or commission and may not necessarily represent actual transactions.

<u>Quarter</u>	<u>High</u>	<u>Low</u>
Year ended December 31, 2002:		
Fourth quarter	\$ 8.85	\$8.37
Third quarter	\$ 9.65	\$7.45
Second quarter	\$10.25	\$8.30
First quarter	\$ 8.91	\$7.10
Year ended December 31, 2001:		
Fourth quarter	\$ 8.00	\$6.55
Third quarter	\$ 8.50	\$6.50
Second quarter	\$ 9.38	\$7.82
First quarter	\$ 9.69	\$7.75

As of March 25, 2003, there were approximately 1,200 holders of Common Stock. There are no other classes of common equity outstanding.

Dividends

Under California law, the holders of common stock of a bank are entitled to receive dividends when and as declared by the Board of Directors, out of funds legally available therefor. The California Banking Law 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 Department 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. In the event that the Department 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 Department may order a bank to refrain from making such a proposed distribution.

The FDIC and the Department have authority to prohibit a bank from engaging in business practices that are considered to be unsafe or unsound. Depending upon the financial condition of a bank and upon other factors, the FDIC or the Department could assert that payments of dividends or other payments by a bank might be such an unsafe or unsound practice. The FRB has similar authority with respect to a bank holding company.

For regulatory restrictions on payment of dividends by the Company, see Item 1 — "BUSINESS — Regulation and Supervision — Limitations on Dividends."

To date, the Company has not paid cash dividends. It is the current policy of the Company to retain earnings to increase its capital to support growth. Payment of cash dividends in the future will depend upon the Company's earnings and financial condition and other factors deemed relevant by management. Accordingly, it is likely that no cash dividends from the Company will be paid in the foreseeable future.

The Company distributed a 10% stock dividend on February 21, 2000. All share and per share information has been retroactively adjusted to reflect the stock dividends.

Mandatorily Redeemable Cumulative Trust Preferred Securities of Subsidiary Grantor Trust

To enhance regulatory capital and to provide liquidity the Company issued the following mandatorily redeemable cumulative trust preferred securities of subsidiary grantor trusts: In the first quarter of 2000, the Company issued \$7,000,000 aggregate principal amount of 10.875% subordinated debentures due on March 8, 2030 to a subsidiary trust, which in turn issued a similar amount of trust preferred securities. In the third quarter of 2000, the Company issued \$7,000,000 aggregate principal amount of 10.60% subordinated

debentures due on September 7, 2030 to a subsidiary trust, which in turn issued a similar amount of trust preferred securities. In the third quarter of 2001, the Company issued \$5,000,000 aggregate principal amount of Floating Rate Junior Subordinated Deferrable Interest Debentures due on July 31, 2031 to a subsidiary trust, which in turn issued a similar amount of trust preferred securities. In the third quarter of 2002, the Company issued \$4,000,000 aggregate principal amount of Floating Rate Junior Subordinated Deferrable Interest Debentures due on September 26, 2032 to a subsidiary trust, which in turn issued a similar amount of trust preferred securities. Under applicable regulatory guidelines, the Trust Preferred securities currently qualify as Tier I capital. See “Footnote 8 to the Consolidated Financial Statements” on page 54.

Item 6 Selected Financial Data

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

SELECTED FINANCIAL DATA

	At and for Year Ended December 31,				
	2002	2001	2000	1999	1998
	(Dollars in thousands, except per share amounts and ratios)				
INCOME STATEMENT DATA:					
Interest income	\$ 52,756	\$ 65,005	\$ 67,921	\$ 45,418	\$ 38,193
Interest expense	15,237	24,366	25,101	15,398	12,048
Net interest income before provision for probable loan losses	37,519	40,639	42,820	30,020	26,145
Provision for probable loan losses	2,663	1,910	3,159	2,198	1,806
Net interest income after provision for probable loan losses	34,856	38,729	39,661	27,822	24,339
Noninterest income	9,030	6,297	2,877	6,051	3,178
Noninterest expenses	33,209	33,348	34,060	26,598	21,744
Income before income taxes	10,677	11,678	8,478	7,275	5,773
Provision for income taxes	3,500	4,410	3,049	2,606	2,267
Net income	<u>\$ 7,177</u>	<u>\$ 7,268</u>	<u>\$ 5,429</u>	<u>\$ 4,669</u>	<u>\$ 3,506</u>

	At and for Year Ended December 31,				
	2002	2001	2000	1999	1998
	(Dollars in thousands, except per share amounts and ratios)				
PER SHARE DATA(1):					
Basic net income(2)	\$ 0.64	\$ 0.66	\$ 0.51	\$ 0.47	\$ 0.39
Diluted net income(3)	\$ 0.63	\$ 0.64	\$ 0.49	\$ 0.43	\$ 0.35
Book value(4)	\$ 7.39	\$ 6.71	\$ 6.01	\$ 5.81	\$ 4.45
Weighted average number of shares outstanding — basic	11,157,287	11,082,157	10,607,584	9,885,036	8,990,769
Weighted average number of shares outstanding — diluted	11,417,972	11,379,721	11,108,329	10,922,977	9,916,907
Shares outstanding at period end	11,214,414	11,114,967	10,939,124	9,737,739	9,433,773
BALANCE SHEET DATA:					
Investment securities	\$ 126,443	\$ 106,810	\$ 110,802	\$ 74,819	\$ 127,217
Net loans	\$ 660,680	\$ 621,763	\$ 601,130	\$ 394,729	\$ 332,862
Allowance for probable loan losses	\$ 13,227	\$ 11,154	\$ 9,651	\$ 6,511	\$ 5,069
Total assets	\$ 958,752	\$ 912,730	\$ 846,224	\$ 677,233	\$ 581,404
Total deposits	\$ 841,936	\$ 807,908	\$ 738,186	\$ 601,420	\$ 509,916
Other borrowed funds	\$ —	\$ —	\$ 18,000	\$ 12,000	\$ 22,500
Trust preferred securities	\$ 23,000	\$ 19,000	\$ 14,000	\$ —	\$ —
Total shareholders' equity	\$ 82,865	\$ 74,574	\$ 65,733	\$ 56,544	\$ 41,991
SELECTED PERFORMANCE RATIOS:					
Return on average assets(5)	0.77%	0.84%	0.70%	0.79%	0.74%
Return on average equity	9.14%	10.23%	9.07%	9.68%	9.60%
Net interest margin	4.39%	5.00%	5.95%	5.56%	6.03%
Efficiency	71.34%	71.05%	74.53%	73.74%	74.15%
Average net loans as a percentage of average deposits . . .	77.95%	78.21%	75.44%	71.88%	62.35%
Average total shareholders' equity as a percentage of average total assets	8.46%	8.18%	7.69%	8.15%	7.68%
SELECTED ASSET QUALITY RATIOS(6):					
Net loan charge-offs to average loans	0.09%	0.07%	—%	0.20%	—%
Allowance for loan losses to total loans	1.96%	1.76%	1.58%	1.62%	1.50%
CAPITAL RATIOS(7):					
Tier 1 risk-based	12.2%	11.8%	10.5%	11.3%	9.4%
Total risk-based	13.4%	13.0%	11.7%	12.5%	10.5%
Leverage	10.8%	10.2%	9.3%	8.5%	7.3%

Notes:

- (1) All share figures are adjusted to reflect (i) a 3-for-2 stock split paid to shareholders of record as of February 5, 1999 and (ii) a 10% stock dividend paid to shareholders of record as of February 7, 2000.
- (2) Represents net income divided by the average number of shares of common stock outstanding for the respective period.

- (3) Represents net income divided by the average number of shares of common stock and common stock-equivalents outstanding for the respective period.
- (4) Represents shareholders' equity divided by the number of shares of common stock outstanding at the end of the period indicated.
- (5) Average balances used in this table and throughout this Annual Report are based on daily averages.
- (6) Nonperforming assets consist of nonaccrual loans, loans past due 90 days or more and still accruing, restructured loans, and foreclosed assets. As of December 31, 2002, the Company had \$4,571,000 in nonperforming assets. As of December 31, 2001 and 2000, the Company had no nonperforming assets. As of December 31, 1999, the Company had \$1,402,000 in nonperforming assets. As of December 31, 1998, the Company had \$1,354,000 in nonperforming assets.
- (7) The Risk-Based and Leverage Capital ratios are defined in Item 1 — "BUSINESS — Supervision And Regulation — Capital Adequacy Guidelines."

Item 7 *Management's Discussion and Analysis of Financial Condition and Results of Operations*

Certain matters discussed or incorporated by reference in this Annual Report on Form 10-K including, but not limited to matters described in this section are forward looking statements that are subject to risks and uncertainties that could cause actual results to differ materially from those projected. See "Item 1 — Business — Forward-looking Statements"

Critical Accounting Policies

General

HCC's financial statements are prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). The financial information contained within our financial statements is, to a significant extent, based on approximate measures of the financial effects of transactions and events that have already occurred. A variety of factors could affect the ultimate value that is obtained either when earning income, recognizing an expense, recovering an asset or relieving a liability. In certain instances, we use a discount factor and prepayment assumptions to determine the present value of assets and liabilities. A change in the discount factor or prepayment spreads could increase or decrease the values of those assets and liabilities which would result in either a beneficial or adverse impact to our financial results. We use historical loss factors as one factor in determining the inherent loss that may be present in our loan portfolio. Actual losses could differ significantly from the historical factors that we use. The Company applies Accounting Principles Board ("APB") No. 25, "Accounting for Stock Issued to Employees" and related interpretations to account for its stock option plan awards. Other estimates that we use are related to the expected useful lives of our depreciable assets. In addition GAAP itself may change from one previously acceptable method to another method. Although the economics of our transactions would be the same, the timing of events that would impact our transactions could change.

Allowance for Loan Losses

The allowance for loan losses is an estimate of the losses that may be sustained in our loan portfolio. The allowance is based on two basic principles of accounting. (1) Statement of Financial Accounting Standards (SFAS) No. 5 "Accounting for Contingencies", which requires that losses be accrued when they are probable of occurring and estimable and (2) SFAS No. 114, "Accounting by Creditors for Impairment of a Loan", which requires that losses be accrued based on the differences between that value of collateral, present value of future cash flows or values that are observable in the secondary market and the loan balance.

The Company's allowance for loan losses has three basic components: the formula allowance, the specific allowance and the unallocated allowance. Each of these components is determined based upon estimates that can and do change when the actual events occur. The formula allowance uses an historical loss view as an indicator of future losses and, as a result formula losses could differ from the loss incurred in the future. The specific allowance uses various techniques to arrive at an estimate of loss. Historical loss information, and fair

market value of collateral are used to estimate those losses. The use of these values is inherently subjective and our actual losses could differ from the estimates. The unallocated allowance captures losses that are attributable to various economic events, industry or geographic sectors whose impact on the portfolio have occurred but have yet to be recognized in either the formula or specific allowances. For further information regarding our allowance for credit losses, see Allowance for Probable Loan Losses on page 38.

Loan Sales and Servicing

The amounts of gains recorded on sales of loans and the initial recording of servicing assets and interest only strips is based on the estimated fair values of the respective components. In recording the initial value of the servicing assets and the fair value of the I/O strips receivable, the Company uses estimates which are made based on management's expectations of future prepayment and discount rates. For the year ended December 31, 2002, management's estimate of constant prepayment rate ("CPR") was 14% and the weighted average discount rate assumption was 10%. These prepayment and discount rates were based on current market conditions and historical performance of the various pools. If actual prepayments with respect to sold loans occur more quickly than projected the carrying value of the servicing assets may have to be adjusted through a charge to earnings. A corresponding decrease in the value of the I/O strip receivable would also be expected.

Stock Based Compensation

Under APB No. 25, compensation cost for stock options is measured as the excess, if any, of the fair market value of the Company's stock at the date of the grant over the amount required to be paid to the Company by the optionee upon exercising the option. Because the Company's stock option plan provides for the issuance of options at a price of no less than the fair market value at the date of the grant, no compensation cost is required to be recognized for the stock option plan on the date of grant. For further information see Note 1 to the Consolidated Financial Statements in "Item 15 — Exhibits, Financial Statement Schedules, and Reports on Form 8-K".

Results of Operations

Overview

For the year ended December 31, 2002, consolidated net income was \$7,177,000, or \$0.63 per diluted share compared to \$7,268,000, or \$0.64 per diluted share and \$5,429,000, or \$0.49 per diluted share for the years ended December 31, 2001 and 2000, respectively. The decrease in 2002 from 2001 was primarily a result of the full year effect of the declining interest rate environment that impacted the Company's net interest margin. Although the level of earning assets increased during 2002, the growth was not able to offset the impact of the declining rates. The overall effect on net income was eased by the increase in noninterest income from gains on sales of loans and securities, services charges and other fees, servicing income and other noninterest income. The increase in 2001 over 2000 was primarily a result of the growth in the level of earning assets, funded by new deposits and the gains on sales of SBA loans and securities offset by the effects of the declining interest rate environment.

Average interest earning assets for 2002 were up 5% over 2001. The increase was primarily attributable to growth in loans. The average rate on interest earning assets decreased to 6.17% in 2002 from 7.99% in 2001 and 9.43% in 2000 reflective of the FRB's 50 basis points reduction in 2002 and 475 basis point reduction in 2001 in short term interest rates. Average interest bearing liabilities for 2002 were up 6% over 2001, with the increase primarily attributable to growth in interest bearing demand deposits, savings and money-market accounts and brokered deposits offset by a decrease in time deposits. The Company's average rate paid on interest bearing liabilities decreased to 2.43% in 2002 from 4.12% in 2001 and 4.75% in 2000, reflective of the declining interest rate environment in 2002 and 2001, and the timing of the Company's repricing of its interest bearing deposits. As a result, net interest margin decreased 61 basis points to 4.39% in 2002, compared to a 95 basis point decrease to 5.00% in 2001 from 5.95% in 2000.

Total noninterest income was \$9,030,000 in 2002, compared to \$6,297,000 in 2001, and \$2,877,000 in 2000. The primary components of noninterest income in 2002 included \$2,262,000 in gains on sales of SBA loans, \$1,036,000 in gains on sales of securities, \$1,113,000 in other investments, primarily due to the increase in the cash surrender value of Corporate Owned Life Insurance, \$1,324,000 in servicing income, and \$1,425,000 in service charges and other fees. Noninterest income in 2001 included \$1,758,000 in gains on sales of SBA loans, \$732,000 in gains on sales of securities, \$967,000 in service charges and other fees, and \$1,029,000 in the increase in the cash surrender value of Corporate Owned Life Insurance. Noninterest income in 2000 included \$716,000 in service charges and other fees, and \$778,000 in the increase in the cash surrender value of Corporate Owned Life Insurance.

Total noninterest expense was \$33,209,000 in 2002, down slightly from \$33,348,000 in 2001, and \$34,060,000 in 2000. Salaries and employee benefits, the single largest component of operating expenses, was \$18,116,000 for 2002, consistent with \$18,120,000 for 2001, and \$16,127,000 in 2000. Decreases in client services expenses and advertising and promotion were offset by increases in the other areas of noninterest expenses. For 2001 compared to 2000, the decrease of \$3,164,000 in pretax merger-related expenses relating to the merger with Western Holdings Bancorp was offset by increases in salaries and benefits of \$1,993,000, occupancy and equipment expenses of \$572,000, and advertising and promotion expenses, loan origination costs, and stationery and supplies of \$512,000 in support of the overall growth in the Company.

Total assets as of December 31, 2002 were \$958,752,000, an increase of \$46,022,000, or 5%, from \$912,730,000 as of December 31, 2001. Total deposits as of December 31, 2002 were \$841,936,000, an increase of \$34,028,000, or 4%, from \$807,908,000 as of December 31, 2001.

Total loans portfolio as of December 31, 2002 was \$673,907,000, an increase of \$40,990,000, or 6%, compared to \$632,917,000 as of December 31, 2001. The Company's allowance for probable loan losses was \$13,227,000, or 1.96%, of total loans as of December 31, 2002, compared to \$11,154,000, or 1.76%, of total loans at December 31, 2001.

Nonperforming assets include nonaccrual loans, loans past due 90 days or more and still accruing, restructured loan and foreclosed assets. As of December 31, 2002, nonperforming assets were \$4,571,000. As of December 31, 2001 and 2000 the Company had no nonperforming assets.

The Company's shareholders' equity at December 31, 2002 was \$82,865,000 compared with \$74,574,000 as of December 31, 2001, an 11% increase, which reflects net earnings of \$7,177,000 in 2002, the proceeds from exercise of stock options and the increase in the unrealized gain on securities available-for-sale. Book value per share increased 10% to \$7.39 as of December 31, 2002, compared to \$6.71 as of December 31, 2001 and \$6.01 as of December 31, 2000. The Company's leverage capital ratio increased to 10.8% at December 31, 2002, from 10.2% at December 31, 2001 and 9.3% at December 31, 2000, primarily due to the growth in shareholders' equity and the additional Tier I capital from the \$4.0 million of trust preferred securities issued in 2002.

Return on average equity for the year ended December 31, 2002 was 9.14%, compared to 10.23% for 2001 and 9.07% for 2000. Return on average assets in 2002 was 0.77%, compared to 0.84% in 2001. Return on average assets was 0.70% in 2000.

Net Interest Income and Net Interest Margin

The following 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 yield on average interest earning assets for the periods indicated. Average balances are based on daily averages.

	Year Ended December 31,								
	2002			2001			2000		
	Average Balance	Interest Income/Expense	Average Yield/Rate	Average Balance	Interest Income/Expense	Average Yield/Rate	Average Balance	Interest Income/Expense	Average Yield/Rate
	(Dollars in thousands)								
ASSETS:									
Loans, gross(1)	\$675,295	\$46,609	6.90%	\$645,632	\$57,153	8.85%	\$537,317	\$56,709	10.55%
Investment securities(2)	111,428	5,076	4.56%	96,340	5,269	5.47%	101,211	6,188	6.12%
Interest bearing deposits in banks	6,758	88	1.30%	5,094	157	3.08%	1,330	66	4.97%
Federal funds sold	61,191	983	1.61%	66,490	2,426	3.65%	80,073	4,958	6.19%
Total interest earning assets . . .	854,672	52,756	6.17%	813,556	65,005	7.99%	719,931	67,921	9.43%
Cash and due from banks	37,522			28,795			35,429		
Premises and equipment, net	5,596			6,024			6,803		
Other assets	29,993			20,249			17,026		
Total assets	\$927,783			\$868,624			\$779,189		
LIABILITIES AND SHAREHOLDERS' EQUITY:									
Deposits:									
Demand, interest bearing	\$ 81,011	\$ 719	0.89%	\$ 69,634	\$ 1,099	1.58%	\$ 55,616	\$ 1,014	1.82%
Savings and money-market	275,217	4,778	1.74%	227,344	7,014	3.09%	228,336	9,496	4.16%
Time deposits, under \$100	56,097	1,762	3.14%	78,910	4,237	5.37%	73,058	4,273	5.85%
Time deposits, \$100 and over . . .	129,702	3,572	2.75%	166,268	8,606	5.18%	151,275	8,701	5.75%
Brokered deposits	65,183	2,522	3.87%	30,843	1,641	5.32%	10,544	690	6.55%
Other borrowings	20,784	1,884	9.06%	18,545	1,769	9.54%	9,617	927	9.64%
Total interest bearing liabilities	627,994	15,237	2.43%	591,544	24,366	4.12%	528,446	25,101	4.75%
Demand deposits	211,195			204,114			183,422		
Other liabilities	10,079			1,910			7,433		
Total liabilities	849,268			797,568			719,301		
Shareholders' equity	78,515			71,056			59,888		
Total liabilities and shareholders' equity	\$927,783			\$868,624			\$779,189		
Net interest income/margin		\$37,519	4.39%		\$40,639	5.00%		\$42,820	5.95%

(1) Yields and amounts earned on loans include loan fees of \$4,544,000, \$4,532,000, and \$4,065,000 for the years ended December 31, 2002, 2001, and 2000. Nonaccrual loans of \$4,571,000 for the year ended December 31, 2002, and zero for the years ended December 31, 2001 and 2000 are included in the average balance calculations above.

(2) Interest income is reflected on an actual basis, not a fully taxable equivalent basis and does not include a fair value adjustment.

Net interest income for the year ended December 31, 2002 decreased \$3,120,000, or 8%, to \$37,519,000, compared to \$40,639,000 for 2001. Net interest income for the year ended December 31, 2001 decreased \$2,181,000, or 5%, from \$42,820,000 reported for 2000. The decreases for both years were due primarily to reductions in the short term interest rate. These reductions immediately affected the rates applicable to the majority of the Company's loans; however, the Company's ability to reprice its interest earning liabilities lagged the repricing of its interest earning assets. The decline in net interest income in 2002 was mitigated by the overall increase in the volume of earning assets which contributed a net \$1,931,000. However, the rate decline decreased net interest income by \$5,051,000. Average interest earning assets were up \$41,116,000, or 5%, in 2002 to \$854,672,000 from \$813,556,000 for 2001. The yield on interest earning assets in 2002 was 6.17%, compared to 7.99% in 2001, and 9.43% in 2000.

The Company's average interest bearing liabilities were up \$36,450,000, or 6%, in 2002 to \$627,994,000 compared to \$591,544,000 for 2001. The rate paid on interest bearing liabilities in 2002 was 2.43%, compared to 4.12% in 2001, and 4.75% in 2000.

The following tables show the changes in interest income resulting from changes in the volume of interest earning assets and interest-bearing liabilities and changes in the average rates earned and paid. The total change is shown in the column designated "Net Change" and is allocated in the columns to the left, for the portions attributable to volume changes and rate changes that occurred during the period indicated. Changes due to both volume and rate have been allocated to the change in volume.

	2002 versus 2001			2001 versus 2000		
	Increase (Decrease) Due to Change In:			Increase (Decrease) Due to Change In:		
	Average Volume	Average Rate	Net Change	Average Volume	Average Rate	Net Change
	(Dollars in thousands)					
INTEREST EARNING ASSETS:						
Loans, gross	\$2,047	\$(12,591)	\$(10,544)	\$9,600	\$ (9,156)	\$ 444
Investment securities	687	(880)	(193)	(266)	(653)	(919)
Interest bearing deposits in banks	22	(91)	(69)	116	(25)	91
Federal funds sold	<u>(85)</u>	<u>(1,358)</u>	<u>(1,443)</u>	<u>(496)</u>	<u>(2,036)</u>	<u>(2,532)</u>
Total interest earning assets	<u>\$2,671</u>	<u>\$(14,920)</u>	<u>\$(12,249)</u>	<u>\$8,954</u>	<u>\$(11,870)</u>	<u>\$(2,916)</u>
INTEREST BEARING LIABILITIES:						
Demand, interest bearing	\$ 101	\$ (481)	\$ (380)	\$ 221	\$ (136)	\$ 85
Savings and money-market	831	(3,067)	(2,236)	(31)	(2,451)	(2,482)
Time deposits, under \$100	(717)	(1,758)	(2,475)	314	(350)	(36)
Time deposits, \$100 and over	(1,007)	(4,027)	(5,034)	776	(871)	(95)
Brokered deposits	1,329	(448)	881	1,080	(129)	951
Other borrowings	<u>203</u>	<u>(88)</u>	<u>115</u>	<u>875</u>	<u>(33)</u>	<u>842</u>
Total interest bearing liabilities	<u>\$ 740</u>	<u>\$(9,869)</u>	<u>\$(9,129)</u>	<u>\$3,235</u>	<u>\$(3,970)</u>	<u>\$(735)</u>
Net interest income	<u>\$1,931</u>	<u>\$(5,051)</u>	<u>\$(3,120)</u>	<u>\$5,719</u>	<u>\$(7,900)</u>	<u>\$(2,181)</u>

Provision for Probable Loan Losses

The provision for probable loan losses represents the current period expense associated with maintaining an appropriate allowance for credit losses. The loan loss provision and level of allowance for each period is 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. Periodic fluctuations in the provision for loan losses result from management's assessment of the adequacy of the allowance for probable loan losses; however, actual loan losses may vary from current estimates.

For 2002, the provision for probable loan losses was \$2,663,000, compared to \$1,910,000 for 2001 and \$3,159,000 for 2000. The allowance for probable loan losses represented 1.96%, 1.76%, and 1.58% of total loans at December 31, 2002, 2001, and 2000, respectively. See “Allowance for Probable Loan Losses” on page 38 for additional information.

Noninterest Income

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

	<u>Years Ended December 31,</u>			<u>2002 versus 2001</u>		<u>2001 versus 2000</u>	
	<u>2002</u>	<u>2001</u>	<u>2000</u>	<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>
	(Dollars in thousands)						
Gain on sale of loans	\$2,262	\$1,758	\$ —	\$ 504	29%	\$1,758	—%
Service charges and other fees	1,425	967	716	458	47%	251	35%
Servicing income	1,324	721	236	603	84%	485	206%
Other investments	1,113	1,029	778	84	8%	251	32%
Gain on sale of securities available- for-sale	1,036	732	44	304	42%	688	1,564%
Gain on sale of credit card portfolio . .	172	—	—	172	—%	—	—%
Other income	1,698	1,090	1,103	608	56%	(13)	(1)%
Total	<u>\$9,030</u>	<u>\$6,297</u>	<u>\$2,877</u>	<u>\$2,733</u>	43%	<u>\$3,420</u>	119%

Noninterest income for the year ended December 31, 2002 was \$9,030,000, compared to \$6,297,000 for 2001 and \$2,877,000 for 2000. The increase in 2002 was primarily due to increased sales of SBA loans increasing the gain by \$504,000, an increase in service charges and other fees of \$458,000, an increase in gains on servicing income of \$603,000, and an increase in gains on sales of securities of \$304,000, compared to the same period in 2001. The increased sales of SBA loans were attributable to the strategic focus in 2002 on increasing SBA origination and to take advantage of the favorable market conditions for sales of the guaranteed portions. The interest rate environment in 2002 provided the opportunity for the Company to realize gains on the sale of loans and securities. The increases in service charges and fees were primarily the result of an increase in activity resulting from the growth of the Company. The increases in other investment income of \$84,000 was primarily the result of increases in the cash surrender value of the Corporate Owned Life Insurance policies, which provides a funding source for the Company’s Supplemental Executive Retirement Plan. In addition, noninterest income included a \$172,000 gain on sale of the Company’s credit card portfolio in 2002.

The increase in 2001 over 2000 was primarily due to an increase in gains on sales of SBA loans of \$1,758,000, an increase in gains on sales of securities of \$688,000, an increase in service charges and fees of \$251,000, an increase in servicing income of \$485,000, and an increase of other investment of \$251,000. These increases were due to the focus on increasing SBA origination, the favorable market conditions for sales of loans and securities, the increased activity from the growth in the Company and increases in the cash surrender value of the Corporate Owned Life Insurance policies.

Noninterest Expenses

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

	Years Ended December 31,			2002 versus 2001		2001 versus 2000	
	2002	2001	2000	Amount	Percent	Amount	Percent
	(Dollars in thousands)						
Salaries and benefits	\$18,116	\$18,120	\$16,127	\$ (4)	0 %	\$1,993	12 %
Occupancy	3,168	2,847	2,399	321	11 %	448	19 %
Professional fees	1,563	1,447	1,861	116	8 %	(414)	(22)%
Furniture and equipment	1,503	1,453	1,329	50	3 %	124	9 %
Loan origination costs	1,277	1,335	1,011	(58)	(4)%	324	32 %
Client services	1,100	1,889	1,839	(789)	(42)%	50	3 %
Advertising and promotion	737	1,116	1,029	(379)	(34)%	87	8 %
Stationery & supplies	345	489	388	(144)	(29)%	101	26 %
Telephone	338	358	359	(20)	(6)%	(1)	0 %
Merger-related costs	—	—	3,164	—	— %	(3,164)	(100)%
Other	5,062	4,294	4,554	768	18 %	(260)	(6)%
Total	<u>\$33,209</u>	<u>\$33,348</u>	<u>\$34,060</u>	<u>\$(139)</u>	<u>0 %</u>	<u>\$ (712)</u>	<u>(2)%</u>

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

	2002		2001		2000	
	Amount	% of Total	Amount	% of Total	Amount	% of Total
	(Dollars in thousands)					
Salaries and benefits	\$18,116	55%	\$18,120	54%	\$16,127	47%
Occupancy	3,168	10%	2,847	9%	2,399	7%
Professional fees	1,563	5%	1,447	4%	1,861	5%
Furniture and equipment	1,503	5%	1,453	4%	1,329	4%
Loan origination costs	1,277	4%	1,335	4%	1,011	3%
Client services	1,100	3%	1,889	6%	1,839	5%
Advertising and promotion	737	2%	1,116	3%	1,029	3%
Stationery & supplies	345	1%	489	1%	388	1%
Telephone	338	1%	358	1%	359	1%
Merger-related costs	—	—	—	—	3,164	9%
Other	5,062	14%	4,294	14%	4,554	15%
Total	<u>\$33,209</u>	<u>100%</u>	<u>\$33,348</u>	<u>100%</u>	<u>\$34,060</u>	<u>100%</u>

Noninterest expenses for the year ended December 31, 2002 were \$33,209,000, down slightly from \$33,348,000 for the year ended December 31, 2001, which was down \$712,000, or 2%, from \$34,060,000 for the year ended December 31, 2000.

Salaries and employee benefits, the single largest component of noninterest expenses, were \$18,116,000 for the year ended December 31, 2002, consistent with the \$18,120,000 for 2001. The increase in occupancy and equipment expenses of \$371,000 and increases in professional fees of \$116,000 was in support of the overall growth of the Company. In 2002, client services expense decreased \$789,000 due to a reduction in both the level and pricing for certain of these services during 2002. Other noninterest expenses increased \$768,000 in 2002 compared to 2001. Advertising and promotion fees decreased \$379,000 as certain sponsorships were discontinued in 2002. The most significant change in 2001 over 2000 was the decrease in pretax merger-related expenses due to the merger with Western Holdings Bancorp in 2000 of \$3,164,000. This decrease was

offset by increases in salaries and benefits of \$1,993,000, primarily due to normal merit increases and increase in the number of employees in 2001. The other increases in 2001 in occupancy, equipment, advertising and promotion, loan origination costs and stationary and supplies was in support of the overall growth of the Company and the addition of new facilities.

Provision for Income Taxes

The Company files consolidated federal and combined state income tax returns. Amounts provided for income tax expense are based on income reported for financial statement purposes and do not necessarily represent amounts currently payable under tax laws.

The provision for income taxes was \$3,500,000, \$4,410,000, \$3,049,000 for the years ended December 31, 2002, 2001, and 2000, respectively. The Company's effective tax rates were 32.8%, 37.8%, and 36.0% for the years ended December 31, 2002, 2001, and 2000, respectively. The effective tax rates are lower than the statutory rate of 42% primarily due to the Company purchasing additional Corporate Owned Life Insurance policies on executive officers of the Company, low income housing tax credits, and changes in the level of investments in municipal securities.

Financial Condition

At December 31, 2002, the Company's total assets were \$958,752,000, an increase of 5% from \$912,730,000 at December 31, 2001. Total portfolio loans were \$673,907,000, an increase of 6% from December 31, 2001, and total deposits were \$841,936,000, an increase of 4% from December 31, 2001. The increases reflect the continued internal growth of the Company.

Securities Portfolio

The following table sets forth the carrying value of investment securities at the dates indicated:

	<u>Years Ended December 31,</u>		
	<u>2002</u>	<u>2001</u>	<u>2000</u>
(Dollars in thousands)			
Securities available-for-sale (at fair value)			
U.S. Treasury	\$ 4,740	\$ 3,593	\$ 8,524
U.S. Government Agencies	48,029	53,762	48,202
Municipals	12,134	9,273	14,297
Mortgage-backed securities	44,774	22,839	18,870
CMOs	14,134	—	—
Corporate bonds	2,632	2,067	—
Other debt securities	—	—	1,001
Total securities available-for-sale	<u>\$126,443</u>	<u>\$91,534</u>	<u>\$90,894</u>
Securities held-to-maturity (at amortized cost)			
Mortgage-backed securities	\$ —	\$ 4,381	\$ 5,783
CMOs	—	893	2,215
Municipals	—	<u>10,002</u>	<u>11,910</u>
Total securities held-to-maturity	<u>\$ —</u>	<u>\$15,276</u>	<u>\$19,908</u>

The following table summarizes the amounts and distribution of the Company's investment securities and the weighted average yields as of December 31, 2002:

	<u>Within One Year</u>		<u>After One Year and Within Five Years</u>		<u>After Five Years and Within Ten Years</u>		<u>After Ten Years</u>		<u>Total</u>	
	<u>Amount</u>	<u>Yield</u>	<u>Amount</u>	<u>Yield</u>	<u>Amount</u>	<u>Yield</u>	<u>Amount</u>	<u>Yield</u>	<u>Amount</u>	<u>Yield</u>
(Dollars in thousands)										
Securities available-for-sale:										
U.S. treasury	\$ 1,417	1.56%	\$ 3,323	2.09%	\$ —	—%	\$ —	—%	\$ 4,740	1.94%
U.S. Government Agencies	21,947	5.35%	26,082	3.28%	—	—%	—	—%	48,029	4.22%
Municipals — taxable . . .	1,127	6.67%	556	6.45%	—	—%	—	—%	1,683	6.59%
Municipals — tax exempt	1,290	4.84%	6,204	4.41%	2,957	4.48%	—	—%	10,451	4.48%
Mortgage-backed securities	—	—%	—	—%	1,267	5.33%	43,507	4.95%	44,774	4.96%
CMOs	—	—%	—	—%	2,059	4.65%	12,075	3.77%	14,134	3.90%
Corporate bonds	—	—%	2,632	4.36%	—	—%	—	—%	2,632	4.36%
Total available-for-sale	\$25,781	5.18%	\$38,797	3.47%	\$6,283	4.71%	\$55,582	4.69%	\$126,443	4.42%

Note: Yields on tax exempt municipal securities are not presented on a fully tax equivalent basis.

During 2002, the Company transferred all of its securities categorized as held-to-maturity to the available-for-sale category. The amortized cost of the transferred securities was \$12,778,000 and the related unrealized holding gain was \$841,000. The Company transferred these securities to increase liquid assets and to increase the ability for possible sale of these securities in the future and currently intends to classify all new purchases of securities as available-for-sale.

As of December 31, 2002, the only securities held by the Company where the aggregate book value of the Company's investment in securities of a single issuer exceeded 10% of the Company's shareholders' equity were direct obligations of the U.S. government or U.S. government agencies.

Securities are pledged to meet requirements imposed as a condition of deposit by some depositors, such as political subdivisions (public funds) or of other funds such as bankruptcy trustee deposits. Securities with amortized cost of \$29,710,000 and \$20,084,000 as of December 31, 2002 and 2001 were pledged to secure public and certain other deposits as required by law or contract.

Loans

Total loans (exclusive of loans held for sale) grew to \$673,907,000 at December 31, 2002, up 6% from \$632,917,000 at December 31, 2001, adding to the increase of 4% from \$610,781,000 at December 31, 2000. The Company's allowance for loan losses was \$13,227,000, or 1.96% of total loans, as of December 31, 2002, as compared to \$11,154,000, or 1.76% of total loans, at December 31, 2001, and \$9,651,000, or 1.58% of total loans, at December 31, 2000. As of December 31, 2002, the Company had \$4,571,000 in nonperforming assets. As of December 31, 2001 and 2000, the Company had no nonperforming assets.

The loan portfolio is primarily composed of commercial loans to companies principally engaged in manufacturing, wholesale and service businesses 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. Real estate values in portions of Santa Clara County and neighboring San Mateo County are among the highest in the country at present. 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' abilities to repay their loans.

The following table presents the Company's loans outstanding at year-end by loan type:

	December 31,									
	2002	% of Total	2001	% of Total	2000	% of Total	1999	% of Total	1998	% of Total
	(Dollars in thousands)									
Commercial.....	\$263,144	39%	\$208,713	33%	\$200,846	33%	\$141,101	35%	\$ 95,587	28%
Real estate — mortgage..	259,974	38%	246,119	39%	230,468	38%	153,518	38%	100,870	30%
Real estate — land and construction.....	147,822	22%	174,077	27%	171,325	28%	96,868	24%	86,102	25%
Consumer	2,850	1%	3,833	1%	8,172	1%	10,048	3%	55,656	17%
Total loans	673,790	100%	632,742	100%	610,811	100%	401,535	100%	338,215	100%
Deferred loan costs (fees)	117		175		(30)		(295)		(284)	
Allowance for loan losses	(13,227)		(11,154)		(9,651)		(6,511)		(5,069)	
Loans, net	<u>\$660,680</u>		<u>\$621,763</u>		<u>\$601,130</u>		<u>\$394,729</u>		<u>\$332,862</u>	

The change in the Company's loan portfolio is primarily due to the increase in the commercial and real estate mortgage loan portfolio offset by a decline in consumer loans due to the sale of the credit card portfolio in 2002 and the normal maturation on the real estate land and construction loans. The increase in the commercial and real estate mortgage loan portfolios is due to the Company's continued expansion and focus on originating these types of loans.

The Company's commercial loans are made for working capital, financing the purchase of equipment or for other business purposes. Such 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 Small Business Administration (SBA) and California guaranteed lending programs, and has been approved by the SBA as a lender under the Preferred Loan Program. The Company regularly makes SBA-guaranteed loans and considers such loans to be investment loans; however, the guaranteed portion of these loans may be sold in the secondary market depending on market conditions and, once it is determined they will be sold, are classified as held for sale and carried at the lower of cost or market. In the event of the sale of a guaranteed portion SBA loan, the Company retains the servicing rights for the sold portion. As of December 31, 2002, 2001, and 2000, \$83.0 million, \$50.1 million and \$12.3 million, respectively, in SBA loans were serviced by the Company for others.

The Company's real estate term loans consist primarily of loans made 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. It is the Company's policy to restrict real estate term loans to no more than 80% of the lower of the property's appraised value or the purchase price of the property, depending on the type of property and its utilization. The Company offers both fixed and floating rate loans. Maturities on such loans are generally restricted to between five and ten years (on an amortization ranging from fifteen to twenty-five years with a balloon payment due at maturity); however, SBA and certain other real estate loans easily sold in the secondary market may be granted for longer maturities.

The Company's real estate land and construction loans are primarily interim loans made by the Company to finance the construction of commercial and single family residential properties. These loans are typically short term. The Company utilizes underwriting guidelines to assess the likelihood of repayment from sources such as sale of the property or permanent mortgage financing prior to making the construction loan.

The Company makes consumer loans for the purpose of financing automobiles, various types of consumer goods, and other personal purposes. Additionally, the Company makes equity lines of credit and equity loans available to its clientele. 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 equity loans or lines, real property.

With certain exceptions, the Banks are permitted to make extensions of its credit to any one borrowing entity up to 15% of the Banks' capital and reserves for unsecured loans and up to 25% of the Banks' capital and reserves for secured loans. For HBC these lending limits were \$8.9 million and \$14.9 million at December 31, 2002. For HBEB these lending limits were \$2.0 million and \$3.3 million at December 31, 2002. For HBSV these lending limits were \$1.2 million and \$2.0 million at December 31, 2002. For BLA these lending limits were \$4.3 million and \$7.2 million at December 31, 2002.

The Company does not have any concentrations in its loan portfolio by industry or group of industries, however, 61% and 66% of its net loans were secured by real property as of December 31, 2002 and 2001. This is attributed to a strong local real estate market and the Company's continued focus on these types of lending.

The following table presents the maturity distribution of the Company's loans as of December 31, 2001. The table shows the distribution of such loans between those loans with predetermined (fixed) interest rates and those with variable (floating) interest rates. Floating rates generally fluctuate with changes in the prime rate as reflected in the western edition of The Wall Street Journal. As of December 31, 2002, approximately 90% of the Company's loan portfolio consisted of floating interest rate loans.

	<u>Due in One Year or Less</u>	<u>Year But Less Than Five Years</u>	<u>Over Five Years</u>	<u>Total</u>
	(Dollars in thousands)			
Commercial	\$246,876	\$15,011	\$1,257	\$263,144
Real estate — mortgage	186,567	65,049	8,358	259,974
Real estate — land and construction	147,822	—	—	147,822
Consumer	<u>2,542</u>	<u>308</u>	<u>—</u>	<u>2,850</u>
Total loans	<u>\$583,807</u>	<u>\$80,368</u>	<u>\$9,615</u>	<u>\$673,790</u>
Loans with variable interest rates	\$559,612	\$45,295	\$2,149	\$607,056
Loans with fixed interest rates	<u>24,195</u>	<u>35,073</u>	<u>7,466</u>	<u>66,734</u>
Total loans	<u>\$583,807</u>	<u>\$80,368</u>	<u>\$9,615</u>	<u>\$673,790</u>

HBC, HBEB, HBSV, and BLA are party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its clients. These financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk, in excess of the amounts recognized in the balance sheets.

HBC's exposure to credit loss in the event of non-performance of the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual notional amount of those instruments. HBC uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments. Credit risk is the possibility that a loss may occur because a party to a transaction failed to perform according to the terms of the contract. HBC controls the credit risk of these transactions through credit approvals, limits, and monitoring procedures. Management does not anticipate any significant losses as a result of these transactions.

Commitments to extend credit as of December 31, were as follows:

	<u>2002</u>	<u>2001</u>
	(Dollars in thousands)	
Commitments to extend credit	\$303,510	\$275,796
Standby letters of credit	<u>3,817</u>	<u>2,526</u>
	<u>\$307,327</u>	<u>\$278,322</u>

Commitments to extend credit are agreements to lend to a client as long as there is no violation of conditions established in the contract. Commitments generally have fixed expiration dates or other termination clauses. Since some of the commitments are expected to expire without being drawn upon, the total commitment amount does not necessarily represent future cash requirements. HBC evaluates each client's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by HBC upon extension of credit, is based on management's credit evaluation of the borrower. Collateral held varies but may include cash, marketable securities, accounts receivable, inventory, property, plant and equipment, income-producing commercial properties, and/or residential properties. Fair value of these instruments is not material.

Standby letters of credit are written conditional commitments issued by HBC to guaranty the performance of a client to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to clients. Fair value of these instruments is not material.

Nonperforming Assets

Nonperforming assets consist of nonaccrual loans, loans past due 90 days and still accruing, troubled debt restructurings and other real estate owned. Management generally places loans on nonaccrual status when they become 90 days past due, unless they are well secured and in the process of collection. When a loan is placed on nonaccrual status, any interest previously accrued but not collected is generally reversed from income. Loans are charged off when management determines that collection has become unlikely. Restructured loans are those where HBC have granted a concession on the interest paid or original repayment terms due to financial difficulties of the borrower. Other real estate owned ("OREO") consists of real property acquired through foreclosure on the related underlying defaulted loans. The following table shows nonperforming assets at the dates indicated:

	<u>December 31,</u>				
	<u>2002</u>	<u>2001</u>	<u>2000</u>	<u>1999</u>	<u>1998</u>
	(Dollars in thousands)				
Nonaccrual loans	\$4,571	\$ —	\$ —	\$1,402	\$1,354
Loans 90 days past due and still accruing	—	—	—	—	—
Restructured loans	—	—	—	—	—
Total nonperforming loans	<u>4,571</u>	<u>—</u>	<u>—</u>	<u>1,402</u>	<u>1,354</u>
Foreclosed assets	—	—	—	—	—
Total nonperforming assets	<u>\$4,571</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$1,402</u>	<u>\$1,354</u>
Nonperforming assets as a percentage of period end loans plus foreclosed assets	0.68%	—	—	0.35%	0.40%

As of December 31, 2002, the Company had \$4,571,000 in loans on nonaccrual status, which were considered impaired loans. The impaired loans had a related valuation allowance of \$356,000 as of December 31, 2002. For the year ended December 31, 2002, the average recorded investment in loans for which impairment has been recognized was approximately \$2,235,000. The Company had no loans past due 90 days or more and still accruing interest and no restructured loans as of December 31, 2002. As of December 31, 2001 and 2000, the Company had no loans on nonaccrual status, no significant loans past due 90 days or more and still accruing interest, no restructured loans, no foreclosed assets, and no impaired loans.

The increase in the nonaccrual loans at December 31, 2002 compared to December 31, 2001 is primarily the result of the placement of one commercial real estate loan nonaccrual status during 2002. For the year ended December 31, 2002, 2001 and 2000, the Company had no foregone interest income on nonaccrual loans. For the year ended December 31, 2002, the Company recognized \$134,000 in interest income for cash payments received on nonaccrual loans, compared to zero for both the years ended December 31, 2001 and 2000.

The Company assigns to all of its loans a risk grade consistent with the system recommended by regulatory agencies. Grades range from "Pass" to "Loss" depending on credit quality, with "Pass" representing loans that involve an acceptable degree of risk. Management conducts a critical evaluation of the loan portfolio monthly. This evaluation includes periodic loan by loan review for certain loans to evaluate the level of impairment as well as detailed reviews of other loans (either individually or in pools) based on an assessment of the following factors: past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, collateral value, loan volumes and concentrations, size and complexity of the loans, recent loss experience in particular segments of the portfolio, bank regulatory examination results, and current economic conditions in the Company's marketplace, in particular the state of the technology industry and the real estate market.

This process attempts to assess the risk of loss inherent in the portfolio by segregating loans into four components for purposes of determining an appropriate level of the allowance: "watch," "special mention," "substandard" and "doubtful." Additionally, the Company maintains a program for regularly scheduled reviews of certain new and renewed loans by an outside loan review consultant. Any loans identified during an external review process that expose the Company to increased risk are appropriately downgraded and an increase in the allowance for loan losses is established for such loans. Further, the Company is examined periodically by the FDIC, FRB, and the Department, at which time a further review of loan quality is conducted.

Loans that demonstrate a weakness, for which there is a possibility of loss if the weakness is not corrected, are categorized as "classified." Classified loans include all loans considered as special mention, substandard, 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).

As of December 31, 2002, classified loans were \$27,915,000. These loans constituted 4% of total loans and 29% of capital and reserves as of that date. At December 31, 2001, the principal balance of classified loans was \$14,594,000. These loans constituted 2% of total loans and 17% of capital and reserves at that date. As of December 31, 2000, the principal balance of classified loans was \$5,632,000. These loans constituted 1% of total loans and 7% of capital and reserves as of that date. During the first quarter of 2003, the Bank identified an \$8.3 million commercial credit with risks identified that create doubt about full future repayment under the original terms of the agreement. Although still performing and on an accrual basis, the Company has established a specific reserve for this loan. Other than this loan and the loans already classified at December 31, 2002, the Company has not identified any potential problem loans which would result in these loans being included as nonperforming or classified loans at a future date.

Allowance for Probable Loan Losses

It is the policy of management to maintain the allowance for probable loan losses at a level adequate for risks inherent in the loan portfolio. Based on information currently available to analyze loan loss delinquency and a history of actual charge-offs, management believes that the loan loss allowance 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. Loans are charged against the allowance when management believes that the collectibility of the principal is unlikely. See "Provision for probable loan losses" on page 30.

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

	<u>2002</u>	<u>2001</u>	<u>2000</u>	<u>1999</u>	<u>1998</u>
	(Dollars in thousands)				
Balance, beginning of period	\$11,154	\$ 9,651	\$6,511	\$5,069	\$3,270
Charge-offs:					
Commercial	(936)	(708)	(52)	(203)	(108)
Real estate — mortgage	—	—	—	—	—
Real estate — land and construction	—	—	—	—	—
Consumer	—	(1)	—	(629)	(71)
Total charge-offs	(936)	(709)	(52)	(832)	(179)
Recoveries:					
Commercial	346	301	33	67	137
Real estate — mortgage	—	—	—	—	—
Real estate — land and construction	—	—	—	—	—
Consumer	—	1	—	9	35
Total recoveries	346	302	33	76	172
Net charge-offs	(590)	(407)	(19)	(756)	(7)
Provision for loan losses	2,663	1,910	3,159	2,198	1,806
Balance, end of period	<u>\$13,227</u>	<u>\$11,154</u>	<u>\$9,651</u>	<u>\$6,511</u>	<u>\$5,069</u>
RATIOS:					
Net charge-offs to average loans outstanding	0.09%	0.07%	—%	0.20%	—%
Allowance for loan losses to average loans	2.07%	1.84%	1.80%	1.71%	1.87%
Allowance for loan losses to total loans at end of period	1.96%	1.76%	1.58%	1.62%	1.50%
Allowance for loan losses to nonperforming loans	289%	—%	—%	464%	374%

Charge-offs reflect the realization of losses in the portfolio that were recognized previously through provisions for loan losses. The net charge-offs in 2002 were \$590,000, compared to \$407,000 in 2001, \$19,000 in 2000, \$756,000 in 1999 and \$7,000 in 1998. The increase in net charge-offs in 2002 was primarily due to the increase in commercial loan charge-offs. However, historical net charge-offs are not necessarily indicative of the amount of net charge-offs that the Company will realize in the future.

The following table summarizes the allocation of the allowance for loan losses (ALL) by loan type and the allocation as a percent of loans outstanding in each loan category at the dates indicated:

	December 31,									
	<u>2002</u>		<u>2001</u>		<u>2000</u>		<u>1999</u>		<u>1998</u>	
	Allowance	Percent of ALL in each category to total loans	Allowance	Percent of ALL in each category to total loans	Allowance	Percent of ALL in each category to total loans	Allowance	Percent of ALL in each category to total loans	Allowance	Percent of ALL in each category to total loans
	(Dollars in thousands)									
Commercial	\$ 6,349	2.41%	\$ 5,489	2.63%	\$4,244	2.11%	\$3,069	2.18%	\$1,961	2.05%
Real estate — mortgage	2,411	0.93%	1,420	0.58%	1,509	0.65%	1,025	0.67%	617	0.61%
Real estate — land and construction	3,574	2.42%	3,066	1.76%	2,084	1.22%	1,343	1.39%	1,173	1.36%
Consumer	47	1.63%	102	2.66%	158	1.93%	170	1.69%	1,245	2.24%
Unallocated	846	—%	1,077	—%	1,656	—%	904	—%	73	—%
Total	<u>\$13,227</u>	1.96%	<u>\$11,154</u>	1.76%	<u>\$9,651</u>	1.58%	<u>\$6,511</u>	1.62%	<u>\$5,069</u>	1.50%

The increase in the allowance for probable loan losses reflects the growth in the Company's overall level of loans, primarily in the commercial and real estate loan portfolio.

Loans are charged against the allowance when management believes that the collectibility of the principal is doubtful. The Company's methodology for assessing the appropriateness of the allowance consists of several key elements, which include specific allowances, the formula allowance and the unallocated allowance.

Specific allowances are established in cases where management has identified significant conditions or circumstances related to a credit that management believes indicate the probability that a loss may be incurred in excess of the amount determined by the application of the formula allowance. As of December 31, 2002, nonperforming loans had a related specific valuation allowance of \$356,000. There were no specific allowances allocated as of December 31, 2001 as the Company did not have any impaired loans.

The formula allowance is calculated by applying loss factors to outstanding loans and certain unused commitments. Loss factors are based on management's experience and may be adjusted for significant factors that, in management's judgment, may affect the collectibility of the portfolio as of the evaluation date. Due to the Company's limited historical loss experience, management utilizes their prior industry experience to determine the loss factor for each category of loan. The formula allowance on December 31, 2002 was \$12,381,000, compared to \$10,077,000 on December 31, 2001. The increase was attributable to several factors, most notably a growth in total loans and an increase in certain factors used to estimate the reserve allocations.

The unallocated allowance is based upon management's evaluation of various conditions that are not directly measured in the determination of the formula and specific allowances. The evaluation of the inherent loss with respect to these conditions is subject to a higher degree of uncertainty because they are not identified with specific problem credits or portfolio segments. As of December 31, 2002, the Company's unallocated allowance was \$846,000, compared to \$1,077,000 on December 31, 2001. The decrease in the unallocated allowance was due to the Company's pro-active efforts in addressing the potential impact of changing economic conditions within the market place through an increase in the factors affecting the formula reserve allocations. In evaluating the appropriateness of the unallocated allowance, management considered the following factors:

Bank's Lending Policies and Procedures — Changes in lending policies and procedures, including underwriting standards and collection, charge-off, and recovery practices. Range of potential impact \$85,000 — \$151,000

Economic Conditions — Changes in national and local economic and business conditions, trends, and developments, including the condition of various market segments. Range of potential impact \$141,000 — \$251,000

Changes in the Bank's Lending Management and Staff — Changes in the experience, ability and depth of lending management and other relevant staff. Range of potential impact \$113,000 — \$203,000

Changes in Trend and Volume of Past Due and Classified Loans — Changes in the trend of the volume and severity of past due and classified loans; and trends in the volume of nonaccrual loans, troubled debt restructurings and other loan modifications. Range of potential impact \$169,000 — \$303,000

Quality of the Bank's Loan Review System — Changes in the quality of the Bank's loan review system and the degree of oversight by the Bank's Board of Directors. Range of potential impact \$28,000 — \$50,000

Credit Concentrations — The existence and effect of any concentrations of credit and changes in the level of such concentrations. Range of potential impact \$56,000 — \$100,000

There can be no assurance that the adverse impact of any of these conditions on the Bank will not be in excess of the ranges set forth above.

The current business, economic, and real estate markets along with the seasoning of the portfolio and the nature and duration of the current business cycle will effect the amount of unallocated reserve.

In an effort to improve its analysis of risk factors associated with its loan portfolio, the Company continues to monitor and to make appropriate changes to its internal loan policies. These efforts better enable the Company to assess risk factors prior to granting new loans and to assess the sufficiency of the allowance for loan losses.

Management believes that it has adequately provided an allowance for estimated probable losses in the credit portfolio. Significant deterioration in Northern California real property values or economic downturns could impact future operating results, liquidity or capital resources and require additional provisions to the allowance or cause losses in excess of the allowance.

Deposits

Total deposits were \$841,936,000 at December 31, 2002, an increase of \$34,028,000, or 4%, compared to \$807,908,000 at December 31, 2001. The largest increase was in savings and money market deposits, which increased \$60,423,000 to \$290,417,000 at December 31, 2002, as compared to \$229,994,000 at December 31, 2001. Noninterest bearing deposits increased \$41,979,000 to \$248,616,000 at December 31, 2002 compared to \$206,637,000 at December 31, 2001. Interest bearing demand deposits increased \$13,780,000 to \$94,309,000 at December 31, 2002, as compared to \$80,529,000 at December 31, 2001. Time deposits decreased \$82,154,000 to \$208,594,000 at December 31, 2002, as compared to \$290,748,000 at December 31, 2001.

The following table summarizes the distribution of average deposits and the average rates paid for the periods indicated:

	Years ended December 31,					
	2002		2001		2000	
	Average Balance	Average Rate Paid	Average Balance	Average Rate Paid	Average Balance	Average Rate Paid
	(Dollars in thousands)					
Demand, noninterest bearing	\$211,195	—%	\$204,114	—%	\$183,422	—%
Demand, interest bearing	81,011	0.89%	69,634	1.58%	55,616	1.82%
Savings and money market	275,217	1.74%	227,344	3.09%	228,336	4.16%
Time deposits, under \$100	56,097	3.14%	78,910	5.37%	73,058	5.85%
Time deposits, \$100 and over	129,702	2.75%	166,268	5.18%	151,275	5.75%
Time deposits — Brokered Deposits	65,183	3.87%	30,843	5.32%	10,544	6.55%
Total average deposits	<u>\$818,405</u>	1.63%	<u>\$777,113</u>	2.91%	<u>\$702,251</u>	3.44%

As of December 31, 2002, the Company had a deposit mix of 34% in savings and money market accounts, 25% in time deposits, 11% in interest bearing demand accounts, and 30% in noninterest bearing demand deposits. On the same date, approximately \$5,257,000, or less than 1%, of deposits were from public sources, and approximately \$90,510,000, or 11%, of deposits were from title companies. As of December 31, 2001, the Company had a deposit mix of 28% in savings and money market accounts, 36% in time deposits, 10% in interest bearing demand accounts, and 26% in noninterest bearing demand deposits. On the same date, approximately \$6,499,000, or less than 1%, of deposits were from public sources, and approximately \$65,792,000, or 8%, of deposits were from title companies.

The Company obtains deposits from a cross-section of the communities it serves. The Company's business is not seasonal in nature. The Company had brokered deposits totaling approximately \$47,640,000 at December 31, 2002 and \$67,995,000 at December 31, 2001. These brokered deposits generally mature within one-year period. The Company is not dependent upon funds from sources outside the United States.

The following table indicates the maturity schedule of the Company's time deposits of \$100,000 or more as of December 31, 2002:

	<u>Balance</u> (Dollars in thousands)	<u>% of Total</u>
Three months or less	\$ 72,553	45%
Over three months through six months	49,105	30%
Over six months through twelve months	18,786	12%
Over twelve months	<u>21,809</u>	<u>13%</u>
Total	<u>\$162,253</u>	<u>100%</u>

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

Liquidity and Asset/Liability Management

To meet liquidity needs, the Company maintains a portion of its funds in cash deposits in other banks, in Federal funds sold, and in investment securities. As of December 31, 2002, the Company's primary liquidity ratio was 16.47%, comprised of \$64.6 million in investment securities available-for-sale of maturities (or probable calls) of up to five years, less \$15.0 million of securities that were pledged to secure public and certain other deposits as required by law and contract; Federal funds sold of \$44.0 million, and \$42.6 million in cash and due from banks, as a percentage of total unsecured deposits of \$827.0 million. As of December 31, 2001, the Company's primary liquidity ratio was 20.27%, comprised of \$65.2 million in investment securities available-for-sale of maturities (or probable calls) of up to five years, less \$9.8 million of securities that were pledged to secure public and certain other deposits as required by law and contract; Federal funds sold of \$71.6 million, and \$34.7 million in cash and due from banks, as a percentage of total unsecured deposits of \$789.1 million. As of December 31, 2000, the Company's primary liquidity ratio was 15.04%, comprised of \$61.2 million in investment securities available-for-sale of maturities (or probable calls) of up to five years, less \$12.0 million securities that were pledged to secure public and certain other deposits as required by law and contract; Federal funds sold of \$19.3 million, and \$40.8 million in cash and due from banks, as a percentage of total unsecured deposits of \$726.2 million.

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

	<u>2002</u>	<u>2001</u>	<u>2000</u>
	(Dollars in thousands)		
Average balance during the year	\$770	\$2,436	\$ 2,020
Average interest rate during the year	1.77%	5.80%	5.17%
Maximum month-end balance during the year	\$ —	\$ —	\$18,000
Average rate at December 31	—	—	5.13%

The Company has Federal funds purchase lines and lines of credit of totaling \$56,000,000. As of December 31, 2002, the Company had no borrowings from the FHLB.

Capital Resources

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

	December 31,			<u>MINIMUM REGULATORY REQUIREMENTS</u>
	2002	2001	2000	
(Dollars in thousands)				
Capital components:				
Tier 1 Capital	\$102,614	\$ 91,598	\$ 78,982	
Tier 2 Capital	<u>10,563</u>	<u>9,664</u>	<u>9,427</u>	
Total risk-based capital	<u>\$113,177</u>	<u>\$101,262</u>	<u>\$ 88,409</u>	
Risk-weighted assets	\$842,399	\$779,060	\$753,947	
Quarterly average assets	\$950,091	\$898,020	\$850,072	
Capital ratios:				
Total risk-based capital	13.4%	13.0%	11.7%	8.0%
Tier 1 risk-based capital	12.2%	11.8%	10.5%	4.0%
Leverage ratio ⁽¹⁾	10.8%	10.2%	9.3%	4.0%

(1) Tier 1 capital divided by average assets (excluding goodwill).

The table above presents the capital ratios of the Company computed in accordance with applicable regulatory guidelines and compared to the standards for minimum capital adequacy requirements under the FDIC's prompt corrective action authority as of December 31, 2002. The risk-based and leverage capital ratios are defined in Item 1 — "Business — Supervision and Regulation — Capital Adequacy Guidelines" on page 8.

At December 31, 2002, 2001 and 2000, the Company's capital met all minimum regulatory requirements. As of December 31, 2002, 2001 and 2000, management believes that HBC, HBEB, HBSV, and BLA were considered "well capitalized" under the regulatory framework for prompt corrective action.

To enhance regulatory capital and to provide liquidity the Company issued the following mandatorily redeemable cumulative trust preferred securities of subsidiary grantor trusts: In the first quarter of 2000, the Company issued \$7,000,000 aggregate principal amount of 10.875% subordinated debentures due on March 8, 2030 to a subsidiary trust, which in turn issued a similar amount of trust preferred securities. In the third quarter of 2000, the Company issued \$7,000,000 aggregate principal amount of 10.60% subordinated debentures due on September 7, 2030 to a subsidiary trust, which in turn issued a similar amount of trust preferred securities. In the third quarter of 2001, the Company issued \$5,000,000 aggregate principal amount of Floating Rate Junior Subordinated Deferrable Interest Debentures due on July 31, 2031 to a subsidiary trust, which in turn issued a similar amount of trust preferred securities. In the third quarter of 2002, the Company issued \$4,000,000 aggregate principal amount of Floating Rate Junior Subordinated Deferrable Interest Debentures due on September 26, 2032 to a subsidiary trust, which in turn issued a similar amount of trust preferred securities. Under applicable regulatory guidelines, the Trust Preferred securities currently qualify as Tier I capital.

Market Risk

Market risk is the risk of loss to future earnings, to fair values, or to future cash flows that may result from changes in the price of a financial instrument. The value of a financial instrument may change as a result of changes in interest rates, foreign currency exchange rates, commodity prices, equity prices and other market changes that affect market risk sensitive instruments. Market risk is attributed to all market risk sensitive financial instruments, including securities, loans, deposits, borrowings, its trading activities for its own account, and its role as a financial intermediary in customer-related transactions. The objective of market risk

management is to avoid excessive exposure of the Company's earnings and equity to loss and to reduce the volatility inherent in certain financial instruments.

Interest Rate Sensitivity

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

The table below sets forth the interest rate sensitivity of the Company's interest earning assets and interest bearing liabilities as of December 31, 2002, using the rate sensitivity GAP ratio. For purposes of the following table, an asset or liability is considered rate-sensitive within a specified period when it can be repriced or when it is scheduled to mature within the specified time frame:

	<u>Due Within Three Months</u>	<u>Due in Three to Twelve Months</u>	<u>Due After One to Five Years</u>	<u>Due After Five Years</u>	<u>Not Rate- Sensitive</u>	<u>Total</u>
	(Dollars in thousands)					
INTEREST EARNING						
ASSETS:						
Federal funds sold	\$ 44,000	\$ —	\$ —	\$ —	\$ —	\$ 44,000
Interest bearing deposits in banks	7,022	—	—	—	—	7,022
Securities	2,817	22,964	38,797	61,865	—	126,443
Total loans, including loans held-for-sale, net of deferred costs	<u>528,044</u>	<u>83,964</u>	<u>80,368</u>	<u>9,615</u>	<u>—</u>	<u>701,991</u>
Total interest earning assets	581,883	106,928	119,165	71,480	—	879,456
Cash and due from banks	—	—	—	—	35,610	35,610
Other assets	—	—	—	—	43,686	43,686
Total assets	<u>\$581,883</u>	<u>\$106,928</u>	<u>\$119,165</u>	<u>\$ 71,480</u>	<u>\$ 79,296</u>	<u>\$958,752</u>
INTEREST BEARING						
LIABILITIES:						
Demand, interest bearing	\$ 94,309	\$ —	\$ —	\$ —	\$ —	\$ 94,309
Savings and money market	290,417	—	—	—	—	290,417
Time deposits	90,844	89,902	27,848	—	—	208,594
Mandatorily redeemable cumulative trust preferred securities	—	—	—	23,000	—	23,000
Total interest bearing liabilities	475,570	89,902	27,848	23,000	—	616,320

	<u>Due Within Three Months</u>	<u>Due in Three to Twelve Months</u>	<u>Due After One to Five Years</u>	<u>Due After Five Years</u>	<u>Not Rate- Sensitive</u>	<u>Total</u>
	(Dollars in thousands)					
Demand noninterest bearing	85,817	—	—	—	162,799	248,616
Accrual interest payable and other liabilities	—	—	—	—	10,951	10,951
Shareholders' equity	—	—	—	—	82,865	82,865
Total liabilities and shareholders' equity	<u>\$561,387</u>	<u>\$ 89,902</u>	<u>\$ 27,848</u>	<u>\$ 23,000</u>	<u>\$ 256,615</u>	<u>\$958,752</u>
Interest rate sensitivity GAP . . .	<u>\$ 20,496</u>	<u>\$ 17,026</u>	<u>\$ 91,317</u>	<u>\$ 48,480</u>	<u>\$(177,319)</u>	<u>\$ —</u>
Cumulative interest rate sensitivity GAP	\$ 20,496	\$ 37,522	\$128,839	\$177,319	\$ —	\$ —
Cumulative interest rate sensitivity GAP ratio	2.14%	3.91%	13.44%	18.49%	—%	—%

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

The process allows the Company to explore the complex relationships within the GAP over time and various interest rate environments. For additional information on the Company's simulation model and the methodology used to estimate the potential effects of changing interest rates, see Item 7A — "Quantitative and qualitative disclosures about market risk" below.

Liquidity risk represents the potential for loss as a result of limitations on the Company's ability to adjust for future cash flows, to meet the needs of depositors and borrowers, and to fund operations on a timely and cost-effective basis. The liquidity policy approved by the board requires annual review of the Company's liquidity by the asset/liability committee, which is composed of senior executives, and the finance and investment committee of the board of directors.

The Company's internal asset/liability committee and the finance and investment committee of the board each meet monthly to monitor the Company's investments, liquidity needs and to oversee its asset/liability management. The Company evaluates the rates offered on its deposit products on a weekly basis.

Item 7A Quantitative and Qualitative Disclosures About Market Risk

As a financial institution, the Company's primary component of market risk is interest rate volatility. Fluctuations in interest rates will ultimately impact both the level of income and expense recorded on most of the Company's assets and liabilities, and the market value of all interest-earning assets, other than those which have a short term to maturity. Since all of the Company's interest-bearing assets and liabilities are located at HBC, all of the Company's interest rate risk exposure lies at that level, as well. As a result, all interest rate risk management procedures are performed at HBC's level. Based upon the nature of the Company's operations, the Company is not subject to foreign exchange or commodity price risk. The Company has no market risk sensitive instruments held for trading purposes. As of December 31, 2002, the Company does not use interest rate derivatives to hedge its interest rate risk.

The Company's exposure to market risk is reviewed on a regular basis by the Asset/Liability Committee (ALCO). Interest rate risk is the potential of economic losses due to future interest rate changes. These economic losses can be reflected as a loss of future net interest income and/or a loss of current fair market

values. The objective is to measure the effect on net interest income and to adjust the balance sheet to minimize the inherent risk while at the same time maximize income. Management realizes certain risks are inherent, and that the goal is to identify and accept the risks. Management uses two methodologies to manage interest rate risk: 1) a standard GAP analysis; and 2) an interest rate shock simulation model.

The detail from the Company's GAP analysis is shown in Item 7, above, and is not discussed here. The Company applies a market value (MV) methodology to gauge its interest rate risk exposure as derived from its simulation model. Generally, MV is the discounted present value of the difference between incoming cash flows on interest earning assets and other investments and outgoing cash flows on interest bearing liabilities and other liabilities. The application of the methodology attempts to quantify interest rate risk as the change in the MV which would result from a theoretical 200 basis point (1 basis point equals 0.01%) change in market interest rates. Both a 200 basis point increase and a 200 basis point decrease in market rates are considered.

At December 31, 2002, it was estimated that the Company's MV would increase 13.19% in the event of a 200 basis point increase in market interest rates. The Company's MV at the same date would decrease 14.02% in the event of a 200 basis point decrease in market interest rates.

Presented below, as of December 31, 2002 and 2001, is an analysis of the Company's interest rate risk as measured by changes in MV for instantaneous and sustained parallel shifts of 200 basis points in market interest rates:

	2002				2001			
	\$ Change in Market Value	% Change in Market Value	Market Value as a % of Present Value of Assets		\$ Change in Market Value	% Change in Market Value	Market Value as a % of Present Value of Assets	
			MV Ratio	Change (bp)			MV Ratio	Change (bp)
	(Dollars in thousands)							
Change in rates								
+ 200 bp	\$ 16,686	13.19%	14.9%	173	\$ 12,254	9.63%	15.3%	134
0 bp	\$ —	—%	13.1%	—	\$ —	—%	14.0%	—
– 200 bp	\$(17,734)	(14.02)%	11.3%	(184)	\$(14,344)	(11.27)%	12.4%	(157)

Management believes that the MV methodology overcomes three shortcomings of the typical maturity gap methodology. First, it does not use arbitrary repricing intervals and accounts for all expected future cash flows. Second, because the MV method projects cash flows of each financial instrument under different interest rate environments, it can incorporate the effect of embedded options on an institutions' interest rate risk exposure. Third, it allows interest rates on different instruments to change by varying amounts in response to a change in market interest rates, resulting in more accurate estimates of cash flows.

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

Liquidity risk represents the potential for loss as a result of limitations on our ability to adjust our future cash flows to meet the needs of depositors and borrowers and to fund operations on a timely and cost-effective basis. The Liquidity Policy approved by the Board requires annual review of the Company's liquidity by the Asset/Liability Committee, which is composed of senior executives, and the Finance and Investment Committee of the Board of Directors.

Item 8 *Financial Statements and Supplementary Data*

The financial statements and independent auditors' report are set forth on pages 55 through 86, which follows Item 15 — "Exhibits, Financial Statement Schedules, and Reports on Form 8-K."

The following table discloses the Company's selected quarterly financial data.

	For the Quarter Ended							
	December 31, 2002	September 30, 2002	June 30, 2002	March 31, 2002	December 31, 2001	September 30, 2001	June 30, 2001	March 31, 2001
Interest income	\$13,344	\$13,051	\$13,290	\$13,071	\$14,198	\$15,855	\$16,807	\$18,145
Interest expense	<u>3,296</u>	<u>3,655</u>	<u>3,994</u>	<u>4,292</u>	<u>5,250</u>	<u>5,803</u>	<u>6,231</u>	<u>7,082</u>
Net interest income	10,048	9,396	9,296	8,779	8,948	10,052	10,576	11,063
Provision for loan losses	<u>597</u>	<u>750</u>	<u>640</u>	<u>675</u>	<u>576</u>	<u>279</u>	<u>528</u>	<u>527</u>
Net interest income after provision	9,451	8,646	8,656	8,104	8,372	9,773	10,048	10,536
Noninterest income	2,793	2,360	1,987	1,890	1,543	1,825	1,691	1,238
Noninterest expense	<u>8,846</u>	<u>8,346</u>	<u>8,317</u>	<u>7,701</u>	<u>7,725</u>	<u>8,687</u>	<u>8,669</u>	<u>8,267</u>
Net income before taxes	3,398	2,660	2,326	2,293	2,190	2,911	3,070	3,507
Provision for income taxes	<u>1,107</u>	<u>848</u>	<u>765</u>	<u>780</u>	<u>816</u>	<u>1,088</u>	<u>1,180</u>	<u>1,326</u>
Net income	<u>\$ 2,291</u>	<u>\$ 1,812</u>	<u>\$ 1,561</u>	<u>\$ 1,513</u>	<u>\$ 1,374</u>	<u>\$ 1,823</u>	<u>\$ 1,890</u>	<u>\$ 2,181</u>
Net income per share basic	\$ 0.20	\$ 0.16	\$ 0.14	\$ 0.14	\$ 0.12	\$ 0.17	\$ 0.17	\$ 0.20
Net income per share diluted	\$ 0.20	\$ 0.16	\$ 0.14	\$ 0.13	\$ 0.12	\$ 0.16	\$ 0.17	\$ 0.19

Item 9 *Changes in and Disagreements with Accountants on Accounting and Financial Disclosure*

None.

PART III

Item 10 *Directors and Executive Officers of the Registrant*

Reference is made to the Company's Proxy Statement for the May 22, 2003 Annual Meeting of Shareholders for incorporation of information concerning directors and persons nominated to become directors of the Company. Information concerning executive officers of the Company also included in the Company's Proxy Statement.

Item 11 *Executive Compensation*

Information concerning executive compensation is incorporated by reference from the text under the caption "Executive Compensation" in the Proxy Statement for the May 22, 2003 Annual Meeting of Shareholders.

Item 12 *Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters*

Information concerning ownership of the equity stock of the Company by certain beneficial owners and management is incorporated by reference from the text under the caption "Proposal One — Election of Directors" in the Proxy Statement for the May 22, 2003 Annual Meeting of Shareholders

Item 13 *Certain Relationships and Related Transactions*

Information concerning certain relationships and related transactions with officers, directors, and the Company is incorporated by reference from the text under the caption “Transactions with Management and Others” in the Proxy Statement for the May 22, 2003 Annual Meeting of Shareholders.

Item 14 *Controls and Procedures*

(a) Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of the effectiveness of our disclosure controls and procedures, as such term is defined under Rule 13a-14(c) promulgated under the Exchange Act, within 90 days of the filing date of this report. Based on their evaluation, our principal executive officer and principal financial officer concluded that the Company’s disclosure controls and procedures are effective.

(b) There have been no significant changes (including corrective actions with regard to significant deficiencies or material weaknesses) in our internal controls or in other factors that could significantly affect these controls subsequent to the date of the evaluation referenced in paragraph (a) above, including any corrective actions with regard to significant deficiencies and material weaknesses.

PART IV

Item 15 *Exhibits, Financial Statement Schedules, and Reports on Form 8-K*

(a)(1) *Financial Statements* The Financial Statements of the Company and the independent auditors’ report are set forth on pages 55 through 86.

(a)(2) *Financial Statement Schedules* All schedules to the Financial Statements are omitted because of the absence of the conditions under which they are required or because the required information is included in the Financial Statements or accompanying notes.

(a)(3) Exhibits

	<u>Filed Herewith</u>	<u>Incorporated by Reference to Form</u>			<u>Exhibit No.</u>
		<u>8-A Dated</u>	<u>10-Q Dated</u>	<u>10-K Dated</u>	
2.1 Agreement and Plan of Merger and Reorganization dated as of May 9, 2000 between Heritage Commerce Corp and Western Holdings Bancorp (incorporated by reference from Annex A of the registration statement on Form S-4, Registration No. 333-40384, filed with the Commission on June 29, 2000)					
3.1 Heritage Commerce Corp Restated Articles of Incorporation as Amended effective June 29, 2001			6-30-01		3.1
3.2 Heritage Commerce Corp Bylaws as amended to September 27, 2001			9-30-01		3.2
4.1 The indenture, dated as of March 23, 2000, between Heritage Commerce Corp, as Issuer, and the Bank of New York, as Trustee				4-6-01 (10-K/A Amendment No. 1)	4.1
4.2 Amended and restated Declaration of Trust, Heritage Capital Trust I, dated as of March 23, 2000				4-6-01 (10-K/A Amendment No. 1)	4.2
4.3 The indenture, date as of September 7, 2000, between Heritage Commerce Corp, as Issuer, and State Street Bank and Trust Company, of Connecticut, National Association, as Trustee				4-6-01 (10-K/A Amendment No. 1)	4.3
4.4 Amended and restated Declaration of Trust by and among State Street Bank and Trust Company of Connecticut, National Association, as Institutional Trustee, and Heritage Commerce Corp, as Sponsor				4-6-01 (10-K/A Amendment No. 1)	4.4
4.5 Heritage Commerce Corp Rights Agreement dated as of November 1, 2001, including Form of Right Certificate attached thereto as Exhibit B		11-15-01			4.5
4.6 The indenture, dated as of July 31, 2001, between Heritage Commerce Corp, as Issuer, and State Street Bank and Trust Company, of Connecticut, National Association, as Trustee				3/28/02	4.6

	<u>Filed Herewith</u>	<u>Incorporated by Reference to Form</u>			<u>Exhibit No.</u>
		<u>8-A Dated</u>	<u>10-Q Dated</u>	<u>10-K Dated</u>	
4.7 The indenture, dated as of July 31, 2001, between Heritage Commerce Corp, as Issuer, and State Street Bank and Trust Company, of Connecticut, National Association, as Trustee				3/28/02	4.7
4.8 The indenture, dated as of September 26, 2002, between Heritage Commerce Corp, as Issuer, and State Street Bank and Trust Company, of Connecticut, National Association, as Trustee	X				4.8
4.9 The indenture, dated as of July 31, 2001, between Heritage Commerce Corp, as Issuer, and State Street Bank and Trust Company, of Connecticut, National Association, as Trustee	X				4.9
10.1 Real Property Leases for properties located at 150 Almaden Blvd., San Jose and 100 Park Center Plaza, San Jose.		3-5-98			10.1
10.2 Employment agreement with Mr. Rossell dated June 8, 1994*		3-5-98			10.2
10.3 Employment agreement with Mr. Gionfriddo dated June 8, 1994*		3-5-98			10.3
10.4 Amendment No. 2 to Employment Agreement with Mr. Gionfriddo*				3-31-98	10.4
10.5 Employment agreement with Mr. Conniff dated April 30, 1998*				3-31-99	10.5
10.6 Employment agreement with Mr. Nethercott dated April 16, 1998*				3-31-99	10.6
10.7 Employment agreement with Mr. McGovern dated July 16, 1998*				3-31-99	10.7
21.1 Subsidiaries of the registrant	X				
23.1 Consent of Deloitte & Touche LLP	X				
99.1 Certification of Registrant's Chief Executive Officer Pursuant to 18 U.S.C. Section 1350	X				
99.2 Certification of Registrant's Chief Financial Officer Pursuant to 18 U.S.C. Section 1350	X				

* Management contract or compensatory plan or arrangement.

(b) Reports on Form 8-K

The Registrant filed Current Reports on Form 8-K dated January 23, 2003 under Item 5, to report its year end 2002 financial results, and containing condensed summarized statements of financial position and results of operations.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report on Form 10-K has been signed below by the following persons on behalf of the registrant and in the capacities and on the date indicated:

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ FRANK BISCEGLIA</u> Frank Bisceglia	Director	March 28, 2003
<u>/s/ JAMES BLAIR</u> James Blair	Director	March 28, 2003
<u>/s/ PHILLIP R. BOYCE</u> Phillip R. Boyce	Director and Chairman of the Board	March 28, 2003
<u>/s/ RICHARD CONNIFF</u> Richard Conniff	Director and President of the Company and Chief Operating Officer	March 28, 2003
<u>/s/ WILLIAM DEL BIAGGIO, JR.</u> William Del Biaggio, Jr.	Director	March 28, 2003
<u>/s/ ANNEKE DURY</u> Anneke Dury	Director	March 28, 2003
<u>/s/ ROY LAVE</u> Roy Lave	Director	March 28, 2003
<u>/s/ LAWRENCE D. MCGOVERN</u> Lawrence D. McGovern	Executive Vice President and Chief Financial Officer, Principal Financial and Accounting Officer	March 28, 2003
<u>/s/ LON NORMANDIN</u> Lon Normandin	Director	March 28, 2003
<u>/s/ JACK PECKHAM</u> Jack Peckham	Director	March 28, 2003
<u>/s/ HUMPHREY POLANEN</u> Humphrey Polanen	Director	March 28, 2003
<u>/s/ KIRK ROSSMANN</u> Kirk Rossmann	Director	March 28, 2003
<u>/s/ BRAD L. SMITH</u> Brad L. Smith	Director and Chief Executive Officer	March 28, 2003
<u>/s/ CHARLES TOENISKOETTER</u> Charles Toeniskoetter	Director	March 28, 2003

CERTIFICATION

(Section 302 of the Sarbanes-Oxley Act of 2002)

I, Brad L. Smith, Chief Executive Officer, certify that:

1. I have reviewed this annual report on Form 10-K of Heritage Commerce Corp;
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
 - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;
 - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the "Evaluation Date"); and
 - c) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors:
 - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officer and I have indicated in this annual report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

/s/ BRAD L. SMITH

Brad L. Smith
Chief Executive Officer

Date: March 28, 2003

CERTIFICATION

(Section 302 of the Sarbanes-Oxley Act of 2002)

I, Lawrence D. McGovern, Chief Financial Officer, certify that:

1. I have reviewed this annual report on Form 10-K of Heritage Commerce Corp;
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
 - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;
 - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the "Evaluation Date"); and
 - c) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors:
 - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officer and I have indicated in this annual report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

/s/ LAWRENCE D. MCGOVERN

Lawrence D. McGovern
Chief Financial Officer

Date: March 28, 2003

**HERITAGE COMMERCE CORP
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DECEMBER 31, 2002**

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INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Shareholders of Heritage Commerce Corp:

We have audited the accompanying consolidated balance sheets of Heritage Commerce Corp and subsidiaries (the "Company") as of December 31, 2002 and 2001, and the related consolidated statements of income, changes in shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2002. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Heritage Commerce Corp and subsidiaries as of December 31, 2002 and 2001, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2002 in conformity with accounting principles generally accepted in the United States of America.

/s/ DELOITTE & TOUCHE LLP

San Jose, California
January 22, 2003

HERITAGE COMMERCE CORP
CONSOLIDATED BALANCE SHEETS

	December 31,	
	2002	2001
	(Dollars in thousands)	
ASSETS		
Cash and due from banks	\$ 42,632	\$ 34,719
Federal funds sold	44,000	71,600
Total cash and cash equivalents	86,632	106,319
Securities available-for-sale, at fair value	126,443	91,534
Securities held-to-maturity, at amortized cost	—	15,276
(fair value of \$15,708 for 2001)		
Loans held for sale, at lower of cost or market	28,084	32,461
Loans, net of deferred costs of \$117 for 2002 and deferred costs of \$175 for 2001	673,907	632,917
Allowance for probable loan losses	(13,227)	(11,154)
Loans, net	660,680	621,763
Premises and equipment, net	5,194	5,470
Accrued interest receivable and other assets	24,549	15,128
Other investments	27,170	24,779
TOTAL	<u>\$958,752</u>	<u>\$912,730</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities:		
Deposits		
Demand, noninterest bearing	\$248,616	\$206,637
Demand, interest bearing	94,309	80,529
Savings and money market	290,417	229,994
Time deposits, under \$100	46,341	72,608
Time deposits, \$100 and over	162,253	218,140
Total deposits	841,936	807,908
Accrued interest payable and other liabilities	10,951	11,248
Mandatorily redeemable cumulative trust preferred securities of subsidiary grantor trust	23,000	19,000
Total liabilities	<u>875,887</u>	<u>838,156</u>
Commitments and contingencies		
Shareholders' equity:		
Preferred stock, no par value; 10,000,000 shares authorized: none outstanding	—	—
Common stock, no par value; 30,000,000 shares authorized; shares outstanding: 11,214,414 in 2002 and 11,114,967 in 2001	63,957	63,536
Accumulated other comprehensive income, net of taxes	1,714	1,021
Retained earnings	17,194	10,017
Total shareholders' equity	<u>82,865</u>	<u>74,574</u>
TOTAL	<u>\$958,752</u>	<u>\$912,730</u>

See notes to consolidated financial statements.

HERITAGE COMMERCE CORP
CONSOLIDATED INCOME STATEMENTS

	<u>Years ended December 31,</u>		
	<u>2002</u>	<u>2001</u>	<u>2000</u>
	(Amounts in thousands, except per share data)		
Interest income:			
Loans, including fees	\$46,609	\$57,153	\$56,709
Securities, taxable	4,576	4,399	5,571
Securities, non-taxable	500	870	617
Interest bearing deposits in banks	88	157	66
Federal funds sold	983	2,426	4,958
Total interest income	<u>52,756</u>	<u>65,005</u>	<u>67,921</u>
Interest expense:			
Deposits	13,353	22,597	24,174
Mandatorily redeemable trust preferred securities	1,871	1,644	823
Other	13	125	104
Total interest expense	<u>15,237</u>	<u>24,366</u>	<u>25,101</u>
Net interest income before provision for probable loan losses	37,519	40,639	42,820
Provision for probable loan losses	2,663	1,910	3,159
Net interest income after provision for probable loan losses	<u>34,856</u>	<u>38,729</u>	<u>39,661</u>
Noninterest income:			
Gain on sale of loans	2,262	1,758	—
Service charges and other fees on deposit accounts	1,425	967	716
Servicing income	1,324	721	236
Other investments	1,113	1,029	778
Gain on sales of securities available-for-sale	1,036	732	44
Gain on sale of credit card portfolio	172	—	—
Other	1,698	1,090	1,103
Total noninterest income	<u>9,030</u>	<u>6,297</u>	<u>2,877</u>
Noninterest expenses:			
Salaries and employee benefits	18,116	18,120	16,127
Occupancy	3,168	2,847	2,399
Professional fees	1,563	1,447	1,861
Furniture and equipment	1,503	1,453	1,329
Loan origination costs	1,277	1,335	1,011
Client services	1,100	1,889	1,839
Advertising and promotion	737	1,116	1,029
Stationery & supplies	345	489	388
Telephone	338	358	359
Merger-related costs	—	—	3,164
Other	5,062	4,294	4,554
Total noninterest expenses	<u>33,209</u>	<u>33,348</u>	<u>34,060</u>
Income before provision for income taxes	10,677	11,678	8,478
Provision for income taxes	3,500	4,410	3,049
Net income	<u>\$ 7,177</u>	<u>\$ 7,268</u>	<u>\$ 5,429</u>
Earnings per share:			
Basic	\$ 0.64	\$ 0.66	\$ 0.51
Diluted	\$ 0.63	\$ 0.64	\$ 0.49

See notes to consolidated financial statements.

HERITAGE COMMERCE CORP
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
Years Ended December 31, 2002, 2001, and 2000

	Common Stock		Accumulated Other Comprehensive Income (Net of Taxes)	Retained Earnings	Total Shareholders' Equity	Other Comprehensive Income
	Shares	Amount				
	(Dollars in thousands)					
Balances, January 1, 2000	9,737,739	\$51,206	\$(1,254)	\$ 6,592	\$56,544	
Net income	—	—	—	5,429	5,429	\$ 5,429
Net change in unrealized loss on securities available-for-sale, net of reclassification adjustment and taxes	—	—	1,769	—	1,769	<u>1,769</u>
Total comprehensive income	—	—	—	—	—	<u>\$ 7,198</u>
Stock dividend	639,444	9,272	—	(9,272)	—	
Cash paid for fractional shares	(325)	(3)	—	—	(3)	
Stock options exercised	<u>562,266</u>	<u>1,994</u>	—	—	<u>1,994</u>	
Balances, December 31, 2000	10,939,124	62,469	515	2,749	65,733	
Net income	—	—	—	7,268	7,268	\$ 7,268
Net change in unrealized gain on securities available-for-sale, net of reclassification adjustment and taxes	—	—	506	—	506	<u>506</u>
Total comprehensive income						<u>\$ 7,774</u>
Stock options exercised	<u>175,843</u>	<u>1,067</u>	—	—	<u>1,067</u>	
Balances, December 31, 2001	11,114,967	63,536	1,021	10,017	74,574	
Net income	—	—	—	7,177	7,177	\$ 7,177
Net change in unrealized gain on securities available-for-sale, net of reclassification adjustment and taxes	—	—	693	—	693	<u>693</u>
Total comprehensive income						<u>\$ 7,870</u>
Stock options exercised	<u>99,447</u>	<u>421</u>	—	—	<u>421</u>	
Balances, December 31, 2002	<u>11,214,414</u>	<u>\$63,957</u>	<u>\$ 1,714</u>	<u>\$ 17,194</u>	<u>\$82,865</u>	

See notes to consolidated financial statements.

HERITAGE COMMERCE CORP
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Years ended December 31,		
	2002	2001	2000
	(Dollars in thousands)		
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	\$ 7,177	\$ 7,268	\$ 5,429
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Loss on disposals of property and equipment	(100)	—	—
Depreciation and amortization	1,828	1,527	777
Provision for probable loan losses	2,663	1,910	3,159
Gain on sales of securities available-for-sale (AFS)	(1,036)	(732)	(44)
Provision for deferred income taxes	(1,188)	2,451	391
Amortization/accretion of discounts and premiums on securities	230	(668)	92
Gain on sale of loans	2,262	1,758	—
Proceeds from sales of loans held for sale	47,676	40,855	—
Originations of loans held for sale	(66,108)	(52,411)	(13,845)
Maturities of loans held for sale	20,547	13,268	157
Effect of changes in:			
Accrued interest receivable and other assets	(8,005)	(4,260)	(3,772)
Accrued interest payable and other liabilities	(782)	671	2,606
Net cash provided by (used in) operating activities	5,164	11,637	(5,050)
CASH FLOWS FROM INVESTING ACTIVITIES:			
Net increase in loans	(41,581)	(22,543)	(209,563)
Purchases of securities available-for-sale (AFS)	(84,260)	(82,098)	(52,042)
Maturities/Paydowns/Calls of securities available-for-sale (AFS)	24,575	24,484	5,230
Proceeds from sales of securities available-for-sale (AFS)	40,033	59,080	9,937
Maturities/Paydowns/Calls of securities held-to-maturity (HTM)	1,776	4,631	3,040
Purchases and earnings of corporate-owned life insurance	(1,863)	(5,989)	(3,763)
Purchase of premises and equipment	(1,452)	(908)	(1,180)
Redemption (purchase) of other investment	(528)	167	(521)
Net cash used in investing activities	(63,300)	(23,176)	(248,862)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Net increase in deposits	34,028	69,722	136,766
Proceeds from issuance of mandatorily redeemable cumulative trust preferred securities of Subsidiary Grantor Trust	4,000	5,000	14,000
Net proceeds from issuance of common stock	421	1,067	1,991
Net change in FHLB borrowings	—	(18,000)	6,000
Net cash provided by financing activities	38,449	57,789	158,757
Net increase (decrease) in cash and cash equivalents	(19,687)	46,250	(95,155)
Cash and cash equivalents, beginning of year	106,319	60,069	155,224
Cash and cash equivalents, end of year	\$ 86,632	\$ 106,319	\$ 60,069
Supplemental disclosures of cash flow information:			
Cash paid during the year for:			
Interest	\$ 17,327	\$ 24,287	\$ 17,324
Income taxes	\$ 4,480	\$ 6,600	\$ 5,974
Supplemental schedule of non-cash investing and financing activity:			
Transfer from retained earnings to common stock for stock dividend	\$ —	\$ —	\$ 9,272
Transfer of investment securities from HTM to AFS	\$ 13,619	\$ —	\$ —

See notes to consolidated financial statements.

HERITAGE COMMERCE CORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(1) Significant Accounting Policies

Description of Business and Basis of Presentation

Heritage Commerce Corp (the “Company”) operates as the bank holding company for four subsidiary banks: Heritage Bank of Commerce (“HBC”), Heritage Bank East Bay (“HBEB”), Heritage Bank South Valley (“HBSV”), and Bank of Los Alto (“BLA”) (collectively the “Banks”). All are California state chartered banks which offer a full range of commercial and personal banking services to residents and the business/professional community in Santa Clara and Alameda Counties, California. HBC was incorporated on November 23, 1993 and commenced operations on June 8, 1994. HBEB was incorporated on October 21, 1998 and commenced operations on December 7, 1998. HBSV was incorporated on December 1, 1999 and commenced operations on January 18, 2000. The merger between Heritage Commerce Corp and Western Holdings Bancorp and its subsidiary, BLA, was effective on October 1, 2000, resulting in BLA operating as a wholly owned subsidiary of the Company. The merger was accounted for as a pooling-of-interests and all amounts have been restated on a historical basis as if the companies had been combined for all periods presented. During 2000, the Company formed two subsidiaries, Heritage Capital Trust I and Heritage Statutory Trust I, during 2001, formed Heritage Statutory Trust II, and during 2002, formed Heritage Statutory Trust III, which are Delaware statutory business trusts formed for the exclusive purpose of issuing and selling trust preferred securities.

During 2002, the Company’s Board of Directors approved the merger of three of its wholly owned commercial bank subsidiaries into the Company’s original wholly owned bank subsidiary. On January 1, 2003, HBEB, HBSV, and BLA were merged into HBC. HBEB, HBSV, and BLA now operate as divisions of HBC and continue to serve their local markets and communities under their current names.

The accounting and reporting policies of the Company and its subsidiary conform to accounting principles generally accepted in the United States of America (“GAAP”) and prevailing practices within the banking industry.

Use of Estimates

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 financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Consolidation

The consolidated financial statements include the accounts of the Company and its subsidiary banks. All significant intercompany accounts and transactions have been eliminated.

Cash and Cash Equivalents

The Company considers all highly liquid debt instruments purchased with remaining terms to maturity of three months or less from the date of acquisition to be cash equivalents. Cash and cash equivalents include cash on hand, amounts due from banks, and federal funds sold. Generally, federal funds are sold and purchased for one-day periods.

Securities

The Company classifies its securities into two categories, available-for-sale and held-to-maturity, at the time of purchase. Securities available-for-sale are recorded at fair value with a corresponding recognition of the net unrealized holding gain or loss, net of income taxes, as a net amount within accumulated other

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

comprehensive income, which is a separate component of shareholders' equity, until realized. Securities held-to-maturity is recorded at amortized cost that are based on the Company's positive intent and ability to hold the securities to maturity. As of December 31, 2002, all the Company's securities were classified as available-for-sale securities.

A decline in the market value of any available-for-sale or held-to-maturity security below cost that is deemed other than temporary results in a charge to earnings and the corresponding establishment of a new cost basis for the security.

Premiums and discounts are amortized, or accreted, over the life of the related investment security as an adjustment to income using a method that approximates the interest method. Interest income is recognized when earned. Realized gains and losses for securities classified as available-for-sale are included in earnings and are derived using the specific identification method for determining the cost of securities sold.

Loans Held for Sale

The Company holds for sale the guaranteed portion of certain Small Business Administration (SBA) loans. These loans are carried at the lower of cost or market, based on the aggregate value of the portfolio.

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

The servicing assets that result from the sale of SBA loans, sold with servicing rights retained, are amortized over the lives of the loans using a method approximating the interest method.

The Company accounts for the transfer and servicing of financial assets based on the financial and servicing assets it controls and liabilities it has incurred, derecognizes financial assets when control has been surrendered, and derecognizes liabilities when extinguished. Servicing assets are measured at their fair value and are amortized in proportion to and over the period of net servicing income and are assessed for impairment on an ongoing basis. Impairment is determined by stratifying the servicing rights based on interest rates and terms. Fair value is determined using prices for similar assets with similar characteristics, when available, or based upon discounted cash flows using market-based assumptions. Impairment is recognized through a valuation allowance. Any servicing assets in excess of the contractually specified servicing fees have been reclassified at fair value as an interest-only (I/O) strip receivable and treated like an available for sale security. The servicing asset, net of any required valuation allowance, and I/O strip receivable are included in other assets.

Loans

Loans are stated at the principal amount outstanding net of deferred loan origination fees and costs. The majority of the Company's loans are at variable interest rates. Interest on loans is credited to income using the effective yield interest method.

Generally, if a loan is classified as non-accrual, the accrual of interest is discontinued, any accrued and unpaid interest is reversed, and the amortization of deferred loan fees and costs is discontinued. Loans are classified as non-accrual when the payment of principal or interest is 90 days past due, unless the amount is well secured and in the process of collection. Any interest or principal payments received on nonaccrual loans are applied toward reduction of principal. Nonaccrual loans generally are not returned to performing status until the obligation is brought current, has performed in accordance with the contract terms for a reasonable period of time, and the ultimate collectibility of the total contractual principal and interest is no longer in doubt.

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Renegotiated loans are those in which the Company has formally restructured a significant portion of the loan. The remaining portion is charged off, with a concession either in the form of below market rate financing, or debt forgiveness on the charged off portion. Loans that have been renegotiated and have not met specific performance standards for payment are classified as renegotiated loans within the classification of nonperforming assets. Upon payment performance, such loans may be transferred from nonperforming status to accrual status. At December 31, 2002 and 2001 the Company did not have any renegotiated loans outstanding.

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

Allowance for Probable Loan Losses

The Company maintains an allowance for probable loan losses to absorb probable losses inherent in the loan portfolio. The allowance is based on ongoing, monthly assessments of the probable estimated losses. Loans are charged against the allowance when management believes that the collectibility of the principal is doubtful. The allowance is increased by the provision for loan losses, which is charged against current period operating results and decreased by the amount of charge-offs, net of recoveries. The Company's methodology for assessing the appropriateness of the allowance consists of several key elements, which include the formula allowance, specific allowances and the unallocated allowance.

The formula allowance is calculated by applying loss factors to outstanding loans and certain unused commitments. Loss factors are based on the Company's historical loss experience and may be adjusted for significant factors that, in management's judgment, affect the collectibility of the portfolio as of the evaluation date.

Specific allowances are established in cases where management has identified significant conditions or circumstances related to a credit that management believes indicate the probability that a loss has been incurred in excess of the amount determined by the application of the formula allowance. The allowance also incorporates the results of measuring 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 note agreement. When a loan is considered to be impaired, the amount of impairment is measured based on the present value of expected future cash flows discounted at the note's effective interest rate, or the fair value of the collateral if the loan is collateral dependent.

The unallocated allowance is based upon management's evaluation of various conditions that are not directly measured in the determination of the formula and specific allowances. The evaluation of the inherent loss with respect to these conditions is subject to a higher degree of uncertainty because they are not identified with specific problem credits or portfolio segments. The conditions evaluated in connection with the unallocated allowance may include existing general economic and business conditions affecting the key lending areas of the Company, in particular the technology industry and the real estate market, credit quality trends, collateral values, loan volumes and concentrations, seasoning of the loan portfolio, specific industry conditions within portfolio segments, recent loss experience in particular segments of the portfolio, duration of the current business cycle, and bank regulatory examination results.

Premises and Equipment

Premises and equipment are stated at cost. Depreciation and amortization are computed on a straight-line basis over the lesser of the lease terms or estimated useful lives of five to fifteen years, if appropriate. The Company evaluates the recoverability of long-lived assets on an on-going basis.

Equipment Under Operating Leases to Others

Equipment under operating leases where the Company is the lessor are carried at cost less accumulated depreciation based on the terms of the leases and is included in other assets.

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Other Investments

Other investments consist of FRB and FHLB stock and the cash surrender value of life insurance policies for certain officers and directors of the Company and its subsidiary banks.

Income Taxes

The Company files consolidated federal and combined state income tax returns. Amounts provided for income tax expense are based on income reported for financial statement purposes and do not necessarily represent amounts currently payable under tax laws. Deferred taxes, which arise principally from temporary differences between the period in which certain income and expenses are recognized for financial accounting purposes and the period in which they affect taxable income, are included in the amounts provided for income taxes. Under this method, the computation of the net deferred tax liability or asset gives current recognition to changes in the tax laws.

Earnings Per Share

Basic earnings per share is computed by dividing net income by the weighted average common shares outstanding. Diluted earnings per share reflects potential dilution from outstanding stock options, using the treasury stock method. For each of the years presented, net income is the same for basic and diluted earnings per share. Reconciliation of weighted average shares used in computing basic and diluted earnings per share is as follows:

	Years ended December 31,		
	2002	2001	2000
Weighted average common shares outstanding — used in computing basic earnings per share	11,157,287	11,082,157	10,607,584
Dilutive effect of stock options outstanding, using the treasury stock method	260,685	297,564	500,745
Shares used in computing diluted earnings per share . . .	11,417,972	11,379,721	11,108,329

Stock-Based Compensation

The Company accounts for stock-based awards to employees using the intrinsic value method in accordance with Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees. No compensation expense has been recognized in the financial statements for employee stock arrangements, as the Company's stock option plan provides for the issuance of options at a price of no less than the fair market value at the date of the grant.

SFAS No. 123, Accounting for Stock-Based Compensation, requires the disclosure of pro forma net income and earnings per share had the Company adopted the fair value method at the grant date of all stock options. Under SFAS No. 123, the fair value of stock-based awards to employees is calculated through the use of option pricing models, even though such models were developed to estimate the fair value of freely tradable, fully transferable options without vesting restrictions, which differ significantly from the Company's stock option awards. Those models also require subjective assumptions, which greatly affect the calculated values. The Company's calculations were made using the Black-Scholes option pricing model with the following weighted average assumptions: expected life, 84 months; risk-free interest rate, 1.2% for 2002, 1.7% for 2001 and 5.7% for 2000; stock volatility of 27% in 2002, 31% in 2001 and 35% in 2000; and no dividends during the expected term. The Company's calculations are based on a multiple option valuation approach, and forfeitures are recognized as they occur.

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Had compensation expense for the Company's stock option plan been determined under the requirements of SFAS No. 123 the Company's pro forma net income and earnings per common share would have been as follows:

	Years ended December 31,		
	2002	2001	2000
	(Amounts in thousands, except per share data)		
Net income			
As reported	\$7,177	\$7,268	\$5,429
Less: Compensation expense for amortization of fair value of stock awards, net of taxes	<u>(752)</u>	<u>(625)</u>	<u>(594)</u>
Pro forma	<u>\$6,425</u>	<u>\$6,643</u>	<u>\$4,835</u>
Net income per common share — basic			
As reported	\$ 0.64	\$ 0.66	\$ 0.51
Pro forma	\$ 0.58	\$ 0.60	\$ 0.46
Net income per common share — diluted			
As reported	\$ 0.63	\$ 0.64	\$ 0.49
Pro forma	\$ 0.56	\$ 0.58	\$ 0.44

Comprehensive Income

Comprehensive income includes net income and other comprehensive income, which represents the changes in its net assets during the period from non-owner sources. The Company's sources of other comprehensive income are unrealized gain and loss on securities available-for-sale and I/O strips, which are treated like available-for-sale securities, and are presented net of tax. Reclassification adjustments resulting from gains or losses on investment securities that were realized and included in net income of the current period that also had been included in other comprehensive incomes as unrealized holding gains and losses in the period in which they are excluded from comprehensive income of the current period. The following is a summary of the components of other comprehensive income.

	Years ended December 31,		
	2002	2001	2000
	(Dollars in thousands)		
Net income	\$7,177	\$7,268	\$5,429
Other comprehensive income, net of tax:			
Net unrealized holding gain on available-for-sale securities during the year	1,389	961	1,797
Less: reclassification adjustment for realized gains on available for sale securities included in net income during the year	<u>696</u>	<u>455</u>	<u>28</u>
Other comprehensive income	<u>693</u>	<u>506</u>	<u>1,769</u>
Comprehensive income	<u>\$7,870</u>	<u>\$7,774</u>	<u>\$7,198</u>

Derivative Instruments and Hedging Activities

The Company, in conjunction with relationships with five of its borrowers, has received warrants to purchase preferred and common stock of these companies, subject to certain restrictions. The Company has determined that such warrants represent embedded derivatives and as such has estimated the value of the

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

warrants and included this amount in other assets. The Company did not enter into freestanding derivatives contracts and was not involved in any hedging activities during 2002, 2001 and 2000.

Segment Reporting

HBC, HBEB, HBSV, and BLA are commercial banks, which offer similar products to customers located in Santa Clara, Alameda, and Contra Costa counties of California. No customer accounts for more than 10 percent of revenue for HBC, HBEB, HBSV, BLA 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 banks all operate as one business segment.

Reclassifications

Certain amounts in the 2001 and 2000 financial statements have been reclassified to conform to the 2002 presentation. These reclassifications had no impact on shareholders' equity or net income.

Business Combinations and Goodwill and Other Intangible Asset

Effective January 1, 2002, the Company adopted SFAS No. 141, "*Business Combinations*" which addresses the elimination of pooling accounting treatment in business combinations and the financial accounting and reporting for acquired goodwill and other intangible assets at acquisition and SFAS No. 142, "*Goodwill and Other Intangible Assets*" which addresses financial accounting and reporting for acquired goodwill and other intangible assets at acquisition in transactions other than business combinations covered by SFAS No. 141, and the accounting treatment of goodwill and other intangible assets after acquisition and initial recognition in the financial statements. The adoption of these statements did not have a material effect on the Company's consolidated financial position, results of operations, or cash flows.

Impairment or Disposal of Long-Lived Assets

Effective January 1, 2002, the Company adopted SFAS No. 144, "*Accounting For The Impairment Or Disposal Of Long-Lived Assets*". SFAS No. 144 supersedes SFAS No. 121, "*Accounting For The Impairment Of Long-Lived Assets And For Long-Lived Assets To Be Disposed Of*" and the accounting and reporting provisions of Accounting Principles Board ("APB") Opinion No. 30, "*Reporting The Results Of Operations — Reporting The Effects Of Disposal Of A Segment Of A Business, And Extraordinary, Unusual and Infrequently Occurring Events And Transactions*". SFAS No. 144 unifies the accounting treatment for various

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

types of long-lived assets to be disposed of, and resolves implementation issues related to SFAS No. 121. The adoption of SFAS No. 144 did not have a material effect on the Company's financial position, results of operations, or cash flows.

Sale-Leaseback Transactions

Effective April 1, 2002, the Company adopted SFAS No. 145, "*Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections*". SFAS No. 145 rescinds and amends these statements to eliminate any inconsistency between the required accounting for sale-leaseback transactions and the required accounting for certain lease modifications that have economic effects that are similar to sale-leaseback transactions. SFAS No. 145 also amends other existing authoritative pronouncements to make various technical corrections, clarify meanings, or describe their applicability under changed conditions including clarification that gains or losses from normal extinguishments of debt need not be classified as extraordinary items. The adoption of SFAS No. 145 did not have a material effect on the Company's financial position, results of operations, or cash flows.

Costs Associated with Exit or Disposal Activities

In June 2002, the FASB issued SFAS No. 146, "*Accounting for Costs Associated with Exit or Disposal Activities*", which addresses accounting for restructuring and similar costs. SFAS No. 146 supersedes previous accounting guidance, principally Emerging Issues Task Force Issue No. 94-3. The Company will adopt the provisions of SFAS No. 146 for restructuring activities initiated after December 31, 2002. SFAS No. 146 requires that the liability for costs associated with an exit or disposal activity be recognized when the liability is incurred. Under Issue No. 94-3, a liability for an exit cost was recognized at the date of the Company's commitment to an exit plan. SFAS No. 146 also establishes that the liability should initially be measured and recorded at fair value. Accordingly, SFAS No. 146 may affect the timing of recognizing future restructuring costs as well as the amounts recognized.

Acquisitions of Certain Financial Institutions

Effective October 1, 2002, the Company adopted SFAS No. 147, "*Acquisitions of Certain Financial Institutions — an Amendment of FASB Statements No. 72 and 144 and FASB Interpretation No. 9*", which removes acquisitions of financial institutions from the scope of both Statement 72 and Interpretation 9 and requires those transactions be accounted for in accordance with FASB Statements No. 141, "*Business Combinations*" and SFAS No. 142, "*Goodwill and Other Intangible Assets*". This Statement is effective for acquisitions on or after October 1, 2002 with earlier application permitted for the transition provisions for previously recorded unidentifiable intangible assets. The adoption of SFAS No. 147 did not have a material effect on the Company's financial position, results of operations, or cash flows.

Stock Based Compensation — Transition and Disclosure

Effective December 31, 2002 the Company adopted SFAS No. 148, "*Accounting for Stock Based Compensation — Transition and Disclosure — an Amendment of FASB Statement No. 123*", which provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation and amends the disclosure requirements of No. 123 to require prominent disclosures in both annual and interim financial statements within the Significant Accounting Policies footnote about the method of accounting for stock-based employee compensation and the effect of the method used (intrinsic value or fair value) on reported results. The Company continues to account for stock-based compensation using the intrinsic value method in accordance with Accounting Principles Board Opinion No. 25, "*Accounting for Stock Issued to Employees*", and presents the required disclosures in accordance with

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

SFAS No. 123 as amended by SFAS No. 148. The adoption of SFAS No. 148 did not have a material effect on the Company's financial position, results of operations, or cash flows.

(2) Business Combinations

In October 2000, the Company merged with Western Holdings Bancorp and its wholly owned subsidiary, BLA, which became a wholly owned subsidiary of Heritage Commerce Corp. Upon consummation of the merger, the outstanding common shares of Western Holdings Bancorp were converted into an aggregate of approximately 3,392,000 shares of Heritage Commerce Corp's common stock based on an exchange ratio of 1.2264 shares of Heritage Commerce Corp common stock for each share of Western Holdings Bancorp common stock. The transaction was accounted for as a pooling-of-interests.

(3) Securities

The amortized cost and estimated fair value of securities as of December 31, 2002 were as follows:

	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Estimated Fair Value</u>
	(Dollars in thousands)			
Securities available-for-sale:				
U.S. Treasury	\$ 4,727	\$ 13	\$ —	\$ 4,740
U.S. Government Agencies	47,072	957	—	48,029
Municipals	11,382	752	—	12,134
FHLMC and FNMA mortgage-backed securities	40,969	290	—	41,259
GNMA mortgage-backed securities	3,378	137	—	3,515
CMOs	14,023	111	—	14,134
Corporate bonds	<u>2,548</u>	<u>84</u>	<u>—</u>	<u>2,632</u>
Total securities available-for-sale	<u>\$124,099</u>	<u>\$2,344</u>	<u>\$ —</u>	<u>\$126,443</u>

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The amortized cost and estimated fair value of securities as of December 31, 2001 were as follows:

	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Estimated Fair Value</u>
	(Dollars in thousands)			
Securities available-for-sale:				
U.S. Treasury	\$ 3,568	\$ 25	\$—	\$ 3,593
U.S. Government Agencies	52,656	1,106	—	53,762
Municipals	8,938	335	—	9,273
FHLMC and FNMA mortgage-backed securities	9,997	102	—	10,099
GNMA mortgage-backed securities	12,768	—	28	12,740
Corporate bonds	<u>2,046</u>	<u>21</u>	<u>—</u>	<u>2,067</u>
Total securities available-for-sale	<u>\$89,973</u>	<u>\$1,589</u>	<u>\$28</u>	<u>\$91,534</u>
Securities held-to-maturity:				
Municipals	\$10,002	\$ 375	\$—	\$10,377
FHLMC and FNMA mortgage-backed securities	2,475	22	—	2,497
GNMA mortgage-backed securities	1,906	18	—	1,924
CMOs	<u>893</u>	<u>17</u>	<u>—</u>	<u>910</u>
Total securities held-to-maturity	<u>\$15,276</u>	<u>\$ 432</u>	<u>\$—</u>	<u>\$15,708</u>

During 2002, the Company transferred all of its securities categorized as held-to-maturity to the available-for-sale category. The amortized cost of the transferred securities was \$12,778,000 and the related unrealized holding gain, which has been included as a component of accumulated comprehensive income, was \$841,000. The Company transferred these securities to increase liquid assets and to increase the ability for possible sale of these securities in the future and currently intends to classify all new purchases of securities as available-for-sale.

The amortized cost and estimated fair values of securities as of December 31, 2002 by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or pre-pay obligations with or without call or pre-payment penalties.

	<u>Available-for-sale</u>	
	<u>Amortized Cost</u>	<u>Estimated Fair Value</u>
	(Dollars in thousands)	
Due within one year	\$ 25,304	\$ 25,781
Due after one through five years	37,709	38,797
Due after five through ten years	5,950	6,283
Due after ten years	<u>55,136</u>	<u>55,582</u>
Total	<u>\$124,099</u>	<u>\$126,443</u>

Sales of securities available-for-sale resulted in gross realized gains of \$1,036,000, \$732,000, and \$44,000 during the years ended December 31, 2002, 2001, and 2000, respectively.

Sales of securities available-for-sale did not result in any gross realized losses for the years ended December 31, 2002, 2001 and 2000.

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Securities with amortized cost of \$29,710,000 and \$20,084,000 as of December 31, 2002 and 2001 were pledged to secure public and certain other deposits as required by law or contract.

(4) Loans

Loans as of December 31 were as follows:

	<u>2002</u>	<u>2001</u>
	(Dollars in thousands)	
Loans held for sale	<u>\$ 28,084</u>	<u>\$ 32,461</u>
Loans held for investment		
Commercial	\$263,144	\$208,713
Real estate — mortgage	259,974	246,119
Real estate — land and construction	147,822	174,077
Consumer	<u>2,850</u>	<u>3,833</u>
Total loans	673,790	632,742
Deferred loan costs	117	175
Allowance for probable loan losses	<u>(13,227)</u>	<u>(11,154)</u>
Loans, net	<u>\$660,680</u>	<u>\$621,763</u>

Changes in the allowance for probable loan losses were as follows:

	<u>Years ended December 31,</u>		
	<u>2002</u>	<u>2001</u>	<u>2000</u>
	(Dollars in thousands)		
Balance, beginning of year	\$11,154	\$ 9,651	\$6,511
Loans charged-off	(936)	(709)	(52)
Recoveries	<u>346</u>	<u>302</u>	<u>33</u>
Net loans charged-off	(590)	(407)	(19)
Provision for probable loan losses	<u>2,663</u>	<u>1,910</u>	<u>3,159</u>
Balance, end of year	<u>\$13,227</u>	<u>\$11,154</u>	<u>\$9,651</u>

As of December 31, 2002, the Company had \$4,571,000 in loans on nonaccrual status, which were considered impaired loans. The impaired loans had a related valuation allowance of \$356,000 as of December 31, 2002. For the year ended December 31, 2002, the average recorded investment in loans for which impairment has been recognized was approximately \$2,235,000. The Company had no loans past due 90 days or more and still accruing interest and no restructured loans as of December 31, 2002. As of December 31, 2001 and 2000, the Company had no loans on nonaccrual status, no significant loans past due 90 days or more and still accruing interest, no restructured loans, no foreclosed assets, and no impaired loans. The increase in the nonaccrual loans at December 31, 2002 compared to December 31, 2001 is primarily the result of the placement of one commercial real estate loan nonaccrual status during 2002. For the year ended December 31, 2002, 2001 and 2000, the Company had no foregone interest income on nonaccrual loans. For the year ended December 31, 2002, the Company recognized \$134,000 in interest income for cash payments received on nonaccrual loans, compared to zero for both the years ended December 31, 2001 and 2000.

Concentrations of credit risk arise when a number of clients are engaged in similar business activities, or activities in the same geographic region, or have similar features that would cause their ability to meet contractual obligations to be similarly affected by changes in economic conditions. The Company's loan

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

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' abilities to repay their loans.

HBC, HBEB, HBSV, and BLA make loans to executive officers, directors, and their affiliates in the ordinary course of business. These transactions were on substantially the same terms as those prevailing at the time for comparable transactions with unrelated parties and do not involve more than normal risk or unfavorable terms for the Bank.

The following table presents the loans outstanding to related parties for the years ended December 31, 2002 and 2001.

	<u>2002</u>	<u>2001</u>
	<u>(Dollars in thousands)</u>	
Beginning balance	\$ 4,077	\$2,075
Advances on loans during the year	7,203	3,214
Repayment on loans during the year	<u>(125)</u>	<u>(1,212)</u>
Ending balance	<u>\$11,155</u>	<u>\$4,077</u>

Loan Servicing

At December 31, 2002 and 2001, the Company serviced loans guaranteed by the Small Business Administration which it had sold to the secondary market of approximately \$83,008,000 and \$50,178,000.

At December 31, 2002 and 2001, the balance of the servicing assets was \$1,538,000 and \$783,000, respectively. There was no valuation allowance as of December 31, 2002 and 2001. At December 31, 2002 and 2001, the balance of the I/O strip receivable was \$2,839,000 net of an unrealized gain of \$463,000 and \$2,142,000 net of an unrealized loss of \$28,000. These assets represent the servicing spread generated from the sold guaranteed portions of SBA loans. Servicing income from these loans was \$1,318,000 and \$366,000 in 2002 and 2001 and not significant in 2000. Amortization of the related assets for 2002 and 2001 was \$837,000 and \$643,000, respectively. In recording the initial value of the servicing assets and the fair value of the I/O strips receivable, the Company uses estimates which are made based on management's expectations of future prepayment and discount rates. For the year ended December 31, 2002, management's estimate of constant prepayment rate ("CPR") was 14% and the weighted average discount rate assumption was 10%. These prepayment and discount rates were based on current market conditions and historical performance of the various pools. If actual prepayments with respect to sold loans occur more quickly than projected the carrying value of the servicing assets may have to be adjusted through a charge to earnings. A corresponding decrease in the value of the I/O strip receivable would also be expected.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

(5) Premises and Equipment

Premises and equipment as of December 31 were as follows:

	<u>2002</u>	<u>2001</u>
	(Dollars in thousands)	
Furniture and equipment	\$5,175	\$6,882
Leasehold improvements	<u>4,285</u>	<u>3,949</u>
	9,460	10,831
Accumulated depreciation and amortization	<u>(4,266)</u>	<u>(5,361)</u>
Premises and equipment, net	<u>\$5,194</u>	<u>\$5,470</u>

Depreciation expense was \$1,828,000 and \$1,527,000, and \$777,000 for the years ended December 31, 2002, 2001, and 2000, respectively.

(6) Deposits

At December 31, 2002, the scheduled maturities of time deposits were as follows:

<u>Year</u>	<u>(Dollars in thousands)</u>
2003	\$180,746
2004	22,426
2005	5,170
2006 and After	<u>252</u>
Total time deposits	<u>\$208,594</u>

(7) Borrowing Arrangements

FHLB Borrowings & Available Lines of Credit

The Company maintains a collateralized line of credit with the Federal Home Loan Bank (the FHLB) of San Francisco. Under this line, the Company can borrow from the FHLB on a short-term (typically overnight) or long-term (over one year) basis. As of December 31, 2002, the Company had no borrowing outstanding from FHLB. At December 31, 2002, the Company has federal funds purchase lines and lines of credit available of \$56,000,000.

	<u>December 31,</u>		
	<u>2002</u>	<u>2001</u>	<u>2000</u>
	(Dollars in thousands)		
FHLB short-term borrowings	\$—	\$—	\$18,000

Information concerning borrowings under the above arrangements is as follows:

	<u>December 31,</u>		
	<u>2002</u>	<u>2001</u>	<u>2000</u>
	(Dollars in thousands)		
Average balance during the year	\$ 770	\$2,436	\$ 2,020
Average interest rate during the year	1.77%	5.80%	5.17%
Maximum month-end balance during the year	\$ —	\$ —	\$18,000
Average rate at December 31	—	—	5.13%

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

(8) Mandatorily Redeemable Cumulative Trust Preferred Securities of Subsidiary Grantor Trust

Heritage Capital Trust I

Heritage Capital Trust I is a Delaware business trust formed by Heritage Commerce Corp for the purpose of issuing Company obligated mandatorily redeemable cumulative trust preferred securities.

During the first quarter of 2000, Heritage Capital Trust I issued 7,000 Trust Preferred Securities with a liquidation value of \$1,000 per security to the Company for gross proceeds of \$7,000,000. The entire proceeds of the issuance were invested by Heritage Capital Trust I in \$7,000,000 aggregate principal amount of 10.875% subordinated debentures due 2030 (the Subordinated Debentures) issued by the Company. The Subordinated Debentures represent the sole assets of Heritage Capital Trust I. The Subordinated Debentures mature on March 8, 2030, bear interest at the rate of 10.875%, payable semi-annually, and are redeemable by the Company at a premium beginning on or after March 8, 2010 based on a percentage of the principal amount of the Subordinated Debentures as stipulated in the Indenture Agreement, plus any accrued and unpaid interest to the redemption date. The Subordinated Debentures are redeemable at 100 percent of the principal amount plus any accrued and unpaid interest to the redemption date at any time on or after March 8, 2020. The Trust Preferred Securities are subject to mandatory redemption to the extent of any early redemption of the Subordinated Debentures and upon maturity of the Subordinated Debentures on March 8, 2030. The Subordinated Debentures bear the same terms and interest rates as the Trust Preferred Securities.

Holders of the trust preferred securities are entitled to cumulative cash distributions at an annual rate of 10.875% of the liquidation amount of \$1,000 per security. The Company has the option to defer payment of the distributions for a period of up to five years, as long as the Company is not in default in the payment of interest on the Subordinated Debentures. The Company has guaranteed, on a subordinated basis, distributions and other payments due on the trust preferred securities (the Guarantee). The Guarantee, when taken together with the Company's obligations under the Subordinated Debentures, the Indenture Agreement pursuant to which the Subordinated Debentures were issued and the Company's obligations under the Trust Agreement governing the subsidiary trust, provide a full and unconditional guarantee of amounts due on the Trust Preferred Securities.

Heritage Statutory Trust I

Heritage Capital Statutory Trust I is a Delaware business trust formed by Heritage Commerce Corp for the purpose of issuing Company obligated mandatorily redeemable cumulative trust preferred securities.

During the third quarter of 2000, Heritage Capital Statutory Trust I issued 7,000 Trust Preferred Securities with a liquidation value of \$1,000 per security to the Company for gross proceeds of \$7,000,000. The entire proceeds of the issuance were invested by Heritage Capital Statutory Trust I in \$7,000,000 aggregate principal amount of 10.60% subordinated debentures due 2030 (the Subordinated Debentures) issued by the Company. The Subordinated Debentures represent the sole assets of Heritage Capital Statutory Trust I. The Subordinated Debentures mature on September 7, 2030, bear interest at the rate of 10.60%, payable semi-annually, and are redeemable by the Company at a premium beginning on or after September 7, 2010 based on a percentage of the principal amount of the Subordinated Debentures as stipulated in the Indenture Agreement, plus any accrued and unpaid interest to the redemption date. The Subordinated Debentures are redeemable at 100 percent of the principal amount plus any accrued and unpaid interest to the redemption date at any time on or after September 7, 2020. The Trust Preferred Securities are subject to mandatory redemption to the extent of any early redemption of the Subordinated Debentures and upon maturity of the Subordinated Debentures on September 7, 2030. The Subordinated Debentures bear the same terms and interest rates as the Trust Preferred Securities.

Holders of the trust preferred securities are entitled to cumulative cash distributions at an annual rate of 10.60% of the liquidation amount of \$1,000 per security. The Company has the option to defer payment of the

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

distributions for a period of up to five years, as long as the Company is not in default in the payment of interest on the Subordinated Debentures. The Company has guaranteed, on a subordinated basis, distributions and other payments due on the trust preferred securities (the Guarantee). The Guarantee, when taken together with the Company's obligations under the Subordinated Debentures, the Indenture Agreement pursuant to which the Subordinated Debentures were issued and the Company's obligations under the Trust Agreement governing the subsidiary trust, provide a full and unconditional guarantee of amounts due on the Trust Preferred Securities.

Heritage Capital Statutory Trust II

Heritage Capital Statutory Trust II is a Delaware business trust formed by Heritage Commerce Corp for the purpose of issuing Company obligated mandatorily redeemable cumulative trust preferred securities.

During the third quarter of 2001, Heritage Capital Statutory Trust II issued 5,000 Floating Rate Capital Securities, with a liquidation value of \$1,000 per security to the Company for gross proceeds of \$5,000,000. The entire proceeds of the issuance were invested by Heritage Capital Statutory Trust II in \$5,000,000 aggregate principal amount of Floating Rate Junior Subordinated Deferrable Interest Debentures, with identical maturity, repricing and payment terms as the Floating Rate Capital Securities (the "Subordinated Debentures") issued by the Company. The Subordinated Debentures represent the sole assets of Heritage Capital Statutory Trust II. The Subordinated Debentures mature on July 31, 2031, bear an initial interest rate of 7.29% (based on 3-month LIBOR plus 3.58%) and the current interest rate is 5.34%, repricing and payable semi-annually, and are redeemable by the Company at a premium beginning on or after July 31, 2006 based on a percentage of the principal amount of the Subordinated Debentures as stipulated in the Indenture Agreement, plus any accrued and unpaid interest to the redemption date. The Subordinated Debentures are redeemable at 100 percent of the principal amount plus any accrued and unpaid interest to the redemption date at any time on or after July 31, 2011 with proper notification. The Floating Rate Capital Securities are subject to mandatory redemption to the extent of any early redemption of the Subordinated Debentures and upon maturity of the Subordinated Debentures on July 31, 2031. The Subordinated Debentures bear the same terms and interest rates as the Floating Rate Capital Securities.

Holders of the Floating Rate Capital Securities are entitled to cumulative cash distribution on the liquidation amount of \$1,000 per security beginning on July 31, 2001 and ending on October 31, 2001 at an initial rate per annum of 7.29% and shall bear interest for each successive period beginning on (and including) October 31, 2001, and each succeeding Distribution Payment Date and ending at the next succeeding Distribution Payment Date at a rate per annum equal to the 3-month LIBOR, plus 3.58% (current interest rate 5.34%); provided, however, that prior to July 31, 2011, such annual rate shall not exceed 12.50%. The distributions on the Floating Rate Capital Securities are treated as interest expense in the consolidated income statements. The Company has the option to defer payment of the distributions for a period of up to five years, as long as the Company is not in default in the payment of interest on the Subordinated Debentures. The Floating Rate Capital Securities issued in the offering were sold in private transactions pursuant to an applicable exemptions from registration under the Securities Act of 1933, as amended. The Company has guaranteed on a subordinated basis, distributions and other payments due on the Floating Rate Capital Securities (the Guarantee). The Guarantee, when taken together with the Company's obligations under the Subordinated Debentures, the Indenture Agreement pursuant to which the Subordinated Debentures were issued and the Company's obligations under the Trust Agreement governing the subsidiary trust, provide a full and unconditional guarantee of amounts due on the Floating Rate Capital Securities.

Heritage Capital Statutory Trust III

Heritage Capital Statutory Trust III is a Delaware business trust formed by the Company for the purpose of issuing Company obligated mandatorily redeemable cumulative trust preferred securities.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

During the third quarter of 2002, Heritage Capital Statutory Trust III issued 4,000 Floating Rate Capital Securities, with a liquidation value of \$1,000 per security to the Company for gross proceeds of \$4,000,000. The entire proceeds of the issuance were invested by Heritage Capital Statutory Trust III in \$4,000,000 aggregate principal amount of Floating Rate Junior Subordinated Deferrable Interest Debentures, with identical maturity, repricing and payment terms as the Floating Rate Capital Securities (the “Subordinated Debentures”) issued by the Company. The Subordinated Debentures represent the sole assets of Heritage Capital Statutory Trust III. The Subordinated Debentures mature on September 26, 2032, bear an initial interest rate of 5.22% (based on 3-month LIBOR plus 3.40%) (current interest rate 4.80%), repricing and payable semi-annually, and are redeemable by the Company at a premium beginning on or after September 26, 2007 based on a percentage of the principal amount of the Subordinated Debentures as stipulated in the Indenture Agreement, plus any accrued and unpaid interest to the redemption date. The Subordinated Debentures are redeemable at 100 percent of the principal amount plus any accrued and unpaid interest to the redemption date at any time on or after September 26, 2012 with proper notification. The Floating Rate Capital Securities are subject to mandatory redemption to the extent of any early redemption of the Subordinated Debentures and upon maturity of the Subordinated Debentures on September 26, 2032. The Subordinated Debentures bear the same terms and interest rates as the Floating Rate Capital Securities.

Holders of the Floating Rate Capital Securities are entitled to cumulative cash distributions on the liquidation amount of \$1,000 per security beginning on September 26, 2002 and ending on December 26, 2002 at an initial rate per annum of 5.22% and for each quarter thereafter at an annualized rate equal to the 3-month LIBOR, plus 3.40%. However, through September 26, 2007 the rate may not exceed 11.90%. The distributions on the Floating Rate Capital Securities are treated as interest expense in the consolidated income statements. The Company has the option to defer payment of the distributions for a period of up to five years, as long as the Company is not in default in the payment of interest on the Subordinated Debentures. The Floating Rate Capital Securities issued in the offering were sold in private transactions pursuant to an applicable exemptions from registration under the Securities Act of 1933, as amended. The Company has guaranteed on a subordinated basis, distributions and other payments due on the Floating Rate Capital Securities (the Guarantee). The Guarantee, when taken together with the Company’s obligations under the Subordinated Debentures, the Indenture Agreement pursuant to which the Subordinated Debentures were issued and the Company’s obligations under the Trust Agreement governing the subsidiary trust, provide a full and unconditional guarantee of amounts due on the Floating Rate Capital Securities.

The total amount of Trust Preferred Securities outstanding at December 31, 2002, 2001 and 2000 was \$23,000,000, \$19,000,000 and \$14,000,000, respectively. The amount of deferred costs at December 31, 2002, 2001 and 2000 was \$647,000, \$548,000 and \$413,000, respectively. The amortization of the deferred costs at December 31, 2002, 2001 and 2000 was \$31,000, \$16,000 and \$13,000, respectively.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

(9) Income Taxes

The provision for income taxes for the years ended December 31, consisted of the following:

	December 31,		
	2002	2001	2000
	(Dollars in thousands)		
Current:			
Federal	\$3,696	\$ 534	\$2,052
State	992	1,425	606
Total current	4,688	1,959	2,658
Deferred:			
Federal	(830)	1,911	184
State	(358)	540	207
Total deferred	(1,188)	2,451	391
Provision for income taxes	\$3,500	\$4,410	\$3,049

The effective tax rate differs from the federal statutory rate for the years ended December 31, as follows:

	December 31,		
	2002	2001	2000
Statutory federal income tax rate	35.0%	35.0%	35.0%
State income taxes, net of federal tax benefit	4.5	4.9	3.1
Merger cost	—	—	6.9
Non-taxable interest income	(1.6)	(2.2)	(3.2)
Officers' life insurance	(3.5)	(3.0)	(3.1)
Other	(1.6)	3.1	(2.7)
Effective tax rate	32.8%	37.8%	36.0%

HERITAGE COMMERCE CORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Net deferred tax asset as of December 31 consists of the following:

	December 31,	
	2002	2001
	(Dollars in thousands)	
Deferred tax assets:		
Allowance for loan losses	\$5,376	\$4,546
Accrued expenses	1,185	1,142
State income taxes	347	484
Net operating loss carryforward	306	396
Other	426	511
Total deferred tax assets	7,640	7,079
Deferred tax liabilities:		
Securities available-for-sale	(1,142)	(609)
Loan fees	(112)	(143)
Other	—	(596)
Total deferred tax liabilities	(1,254)	(1,348)
Net deferred tax assets	\$6,386	\$5,731

The Company believes that it is more likely than not that it will realize the above deferred tax assets in future periods; therefore, no valuation allowance has been provided against its deferred tax assets.

The Company has net operating loss carryforwards of \$875,590 for federal income tax purposes. The net operating losses expire in 2005. These losses related to the entity that was the predecessor of the BLA, and are subject to restrictions as a result of the change of control that limits the maximum annual recovery of the net operating loss to \$290,275. Management has determined that valuation allowance is not necessary.

(10) Stock Based Compensation

The Company has a stock option plan (the Plan) for directors, officers, and key employees. The Plan provides for the grant of incentive and non-qualified stock options. The Plan provides that the option price for both incentive and non-qualified stock options will be determined by the Board of Directors at no less than the fair value at the date of grant. Options granted vest on a schedule determined by the Board of Directors at the time of grant. Generally, options vest over four years. All options expire no later than ten years from the date

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

of grant. As of December 31, 2002, there are 241,682 shares are available for future grants under the Plan. Option activity under the Plan is as follows:

	<u>Number of Shares</u>	<u>Weighted Average Exercise Price</u>
Options Outstanding at January 1, 2000		
(1,475,340 exercisable at a weighted average exercise price of \$5.22)	1,956,234	\$ 6.26
Granted (weighted average fair value of \$5.14)	246,144	\$ 8.17
Exercised	(562,475)	\$ 3.27
Cancelled	<u>(66,070)</u>	<u>\$ 9.14</u>
Options Outstanding at December 31, 2000		
(1,086,985 exercisable at a weighted average exercise price of \$6.54)	1,573,833	\$ 7.79
Granted (weighted average fair value of \$3.14)	181,500	\$ 8.22
Exercised	(175,842)	\$ 3.70
Cancelled	<u>(32,840)</u>	<u>\$10.78</u>
Options Outstanding at December 31, 2001		
(1,148,381 exercisable at weighted average exercise price of \$7.69)	1,546,651	\$ 8.25
Granted (weighted average fair value of \$2.70)	300,500	\$ 8.63
Exercised	(99,447)	\$ 2.80
Cancelled	<u>(149,692)</u>	<u>\$11.14</u>
Options Outstanding at December 31, 2002		
(1,144,948 exercisable at weighted average exercise price of \$8.18)	<u>1,598,012</u>	\$ 8.39

Additional information regarding options outstanding under the Plan as of December 31, 2002 is as follows:

<u>Range of Exercise Prices</u>	<u>Number Outstanding</u>	<u>Remaining Contractual Life (Yrs.)</u>	<u>Average Exercise Price</u>	<u>Number Exercisable</u>	<u>Average Exercise Price</u>
\$1.42 — \$4.41	318,655	1.98	\$ 2.97	318,655	\$ 2.97
\$4.42 — \$5.32	54,889	4.45	\$ 5.23	54,889	\$ 5.23
\$5.33 — \$9.70	755,973	7.92	\$ 8.76	366,680	\$ 8.98
\$9.71 — \$16.37	<u>468,495</u>	6.55	\$11.83	<u>404,724</u>	\$11.95
\$1.42 — \$16.37	<u>1,598,012</u>	6.21	\$ 8.39	<u>1,144,948</u>	\$ 8.18

As discussed in Note 1, the Company continues to account for its stock-based awards using the intrinsic value method in accordance with APB Opinion No. 25, Accounting for Stock Issued to Employees, and its related interpretations. Accordingly, no compensation expense has been recognized in the financial statements for employee stock option arrangements.

(11) Leases

Equipment Under Operating Leases as Lessor

The Company acts as the lessor for certain equipment under operating leases, which are included in other assets in the statement of financial position. These leases represent a pool of equipment leases, primarily

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

electronic testing equipment, purchased in 2002 from a third party, who also services the leases. The agreement with the third party is for 5 years, however, under the terms of the purchase agreement, the third party has the option to repurchase all of the leases beginning at the end of the third year at a predetermined price.

	<u>(Dollars in thousands)</u>
Equipment under operating leases	\$5,000
Accumulated depreciation	<u>83</u>
Equipment under operating leases, net	<u>\$4,917</u>

For the year ended December 31, 2002, depreciation expense was \$83,400 and rental revenue on the lease was \$103,000.

Minimum future rents to be received under this pooled lease purchase agreement assuming the repurchase option is not exercised are as followings:

<u>Year ending December 31,</u>	<u>(Dollars in thousands)</u>
2003	\$1,238
2004	1,238
2005	1,238
2006	1,238
2007	<u>1,135</u>
Total	<u>\$6,087</u>

Operating Leases

The Company leases its premises under non-cancelable operating leases with terms, including renewal options, ranging from five to fifteen years. Future minimum payments under the agreements are as follows:

<u>Year ending December 31,</u>	<u>(Dollars in thousands)</u>
2003	\$ 2,283
2004	2,235
2005	2,251
2006	1,809
2007	1,680
Thereafter	<u>3,250</u>
Total	<u>\$13,508</u>

Rent expense under operating leases was \$2,467,000, \$2,201,000, and \$1,676,000, during the years ended December 31, 2002, 2001, and 2000. Rent expense was reduced by deferred rent concessions on one of the Company's locations of \$46,000 for the year ended December 31, 2002, 2001, and 2000.

(12) Benefit Plans

The Company offers a 401(k) savings plan. All salaried employees are eligible to contribute up to 20% of their pre-tax compensation (to a maximum of \$10,500 in 2002) to the plan through salary deductions under

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Section 401(k) of the Internal Revenue Code. Beginning in 2001, the Company matched up to \$1,500 for each employee's contributions. Contributions paid were \$304,000 and \$313,000 in 2002 and 2001.

The Company also sponsors an employee stock ownership plan. The plan allows the Company to purchase shares on the open market and award those shares to certain employees in lieu of paying cash bonuses. To be eligible to receive an award of shares under this plan, an employee must have worked at least 1,000 hours during the year and must be employed by the Company, or its subsidiaries, on December 31. Awards under this plan generally vest over four years. During 2002, 2001 and 2000, the Company made contributions of \$358,000, \$244,000, and \$250,000 into the Plan. The amount contributed was recognized as salaries and benefits expense in the Company's financial statements. On September 7, 2001, the ESOP borrowed \$1,000,000 from an unaffiliated third party lender in order to fund the purchase of common stock of the Company. This loan is being repaid with annual installments of principal of \$250,000 until September 7, 2005, at which time all outstanding balance on principal together with accrued interest is due and payable. An annual rate of interest, equal to Prime rate plus 0.50% floating on a daily basis, is due on the first day of each month. The funds for repayment will be primarily coming from the Company's contributions to the ESOP over a similar time period. The loan is collateralized by the 127,000 shares of the Company's common stock held by the ESOP. At December 31, 2002, the ESOP owned approximately 202,400 shares of the Company's stock.

The Company also has a nonqualified deferred compensation plan for the directors ("Deferral Plan"). Under the Deferral Plan, a participating director may defer up to 100% of his monthly board fees into the Deferral Plan for up to ten years. Amounts deferred earn interest at the rate of 8% per annum. The director may elect a distribution schedule of up to ten years with interest accruing (at the same 8%) on the declining balance. The Company's deferred compensation obligation of \$250,000 and \$192,000 as of December 31, 2002 and 2001 is included in "Accrued interest payable and other liabilities".

The Company has purchased life insurance policies on the lives of directors who have agreed to participate in the Deferral Plan. It is expected that the earnings on these policies will offset the cost of the program. In addition, the Company will receive death benefit payments upon the death of the director. The proceeds will permit the Company to "complete" the deferral program as the director originally intended if he dies prior to the completion of the deferral program. The disbursement of deferred fees is accelerated at death and commences one month after the director dies.

In the event of the director's disability prior to attainment of his benefit eligibility date, the director may request that the Board permit him to receive an immediate disability benefit equal to the annualized value of the director's deferral account.

The Company has a supplemental retirement plan covering key executives and directors (Plan). The Plan is a nonqualified defined benefit plan and is unsecured and unfunded and there are no Plan assets. The Company has purchased insurance on the lives of the directors and executive officers in the plan and intends to use the cash values of these policies (\$23,898,000 and \$22,034,000 at December 31, 2002 and 2001, respectively) to pay the retirement obligations. The accrued pension obligation was \$3,475,000 and \$2,596,000 as of December 31, 2002 and 2001, respectively, and is included in "Accrued interest payable and other liabilities".

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The following table sets forth the unqualified supplemental retirement defined benefit pension plan's status at December 31:

	<u>2002</u>	<u>2001</u>
	(Dollars in thousands)	
Change in projected benefit obligation		
Projected benefit obligation at beginning of year	\$ 2,399	\$ 2,150
Service cost	636	378
Interest cost	153	113
Actuarial loss/ (gain)	<u>162</u>	<u>(242)</u>
Projected benefit obligation at end of year	<u>\$ 3,350</u>	<u>\$ 2,399</u>
Change in Plan assets		
Fair value of Plan assets at beginning of year	\$ —	\$ —
Fair value of Plan assets at end of year	\$ —	\$ —
Funding		
Unfunded Status	\$(3,350)	\$(2,399)
Unrecognized net actuarial gain	<u>(125)</u>	<u>(197)</u>
Accrued pension cost	<u>\$(3,475)</u>	<u>\$(2,596)</u>
Weighted-average assumptions as of December 31		
Discount rate	7.00%	7.00%
Rate of compensation increase	N/A	N/A
Expected return on Plan assets	N/A	N/A

The elements of pension costs for the unqualified supplemental retirement defined benefit pension plan at December 31, 2002 was as following:

	<u>2002</u>	<u>2001</u>
	(Dollars in thousands)	
Components of net periodic benefits cost		
Service cost	\$636	\$378
Interest cost	153	113
Amortization of loss/ (gain)	<u>130</u>	<u>(25)</u>
Net periodic benefit cost	<u>\$919</u>	<u>\$466</u>

The net periodic pension cost was determined using the following assumptions:

	<u>2002</u>	<u>2001</u>
Discount rate	7.00%	7.00%
Rate of compensation increase	N/A	N/A
Expected return on Plan assets	N/A	N/A

(13) Disclosures of Fair Value of Financial Instruments

The estimated fair value amounts have been determined by using available market information and appropriate valuation methodologies. However, considerable judgment is required to interpret market data to develop the estimates of fair value. Accordingly, the estimates presented are not necessarily indicative of the

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

amounts that could be realized in a current market exchange. The use of different market assumptions and/or estimation techniques may have a material effect on the estimated fair value amounts.

The carrying amounts and estimated fair values of the Company's financial instruments as of December 31, 2002 and 2001 were as follows:

	2002		2001	
	Carrying Amounts	Estimated Fair Value	Carrying Amounts	Estimated Fair Value
	(Dollars in thousands)			
Assets				
Cash and cash equivalents	\$ 86,632	\$ 86,632	\$106,319	\$106,319
Securities	126,443	126,443	106,810	107,242
Loans, including loans held for sale, net	688,764	690,231	654,224	657,336
Other investments	27,170	27,170	24,779	24,779
Liabilities				
Time deposits	\$208,594	\$211,198	\$290,748	\$295,732
Other deposits	633,342	633,342	517,160	517,160
Mandatorily redeemable cumulative trusts preferred securities	23,000	24,716	19,000	19,727

The following methods and assumptions were used to estimate the fair value in the table, above:

Cash and Cash Equivalents

The carrying amount approximates fair value because of the short maturities of these instruments.

Securities

The fair value of securities is estimated based on bid market prices. The fair value of certain municipal securities is not readily available through market sources other than dealer quotations, so fair value estimates are based on such dealer quotations.

Loans, net

Loans with similar financial characteristics are grouped together for purposes of estimating their fair value. Loans are segregated by type such as commercial, term real estate, residential construction, and consumer. Each loan category is further segmented into fixed and adjustable rate interest terms.

The fair value of performing, fixed rate loans is calculated by discounting scheduled future cash flows using estimated market discount rates that reflect the credit and interest rate risk inherent in the loan. The fair value of variable rate loans is the carrying amount as these loans generally reprice within 90 days. The fair value calculations are adjusted by the allowance for possible loan losses.

Other Investments

Other investments consist of FRB and FHLB stock and the cash surrender value of the Company Owned Life Insurance policies. The carrying amount represents a reasonable estimate of fair value.

Deposits

The fair value of deposits with no stated maturity, such as non-interest bearing demand deposits, savings, and money market accounts, approximates the amount payable on demand. The fair value of the demand

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

deposit intangible has not been included in the fair value estimate. The carrying amount approximates the fair value of time deposits with a remaining maturity of less than 90 days. The fair value of all other time deposits is calculated based on discounting the future cash flows using rates currently offered by the Bank for time deposits with similar remaining maturities.

Commitments to Fund Loans/Standby Letters of Credit

The fair values of commitments are estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counterparties. The amounts of and differences between the carrying value of commitments to fund loans or stand by letters of credit and their fair value is not significant and therefore is not included in the table above.

Mandatorily Redeemable Cumulative Trust Preferred Securities of Subsidiary Grantor Trust

The fair value of Mandatorily Redeemable Cumulative Trust Preferred Securities of Subsidiary Grantor Trust was determined based on the current market value for like kind instruments of a similar maturity and structure.

Limitations

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

(14) Commitments and Contingencies

Financial Instruments with Off-Balance Sheet Risk

HBC, HBEB, HBSV, and BLA are party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its clients. These financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk, in excess of the amounts recognized in the balance sheets.

HBC's exposure to credit loss in the event of non-performance of the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual notional amount of those instruments. HBC uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments. Credit risk is the possibility that a loss may occur because a party to a transaction failed to perform according to the terms of the contract. HBC controls the credit risk of these transactions through credit approvals, limits, and monitoring procedures. Management does not anticipate any significant losses as a result of these transactions.

Commitments to extend credit as of December 31, were as follows:

	2002	2001
	(Dollars in thousands)	
Commitments to extend credit	\$303,510	\$275,796
Standby letters of credit	3,817	2,526
	\$307,327	\$278,322

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Commitments to extend credit are agreements to lend to a client as long as there is no violation of conditions established in the contract. Commitments generally have fixed expiration dates or other termination clauses. Since some of the commitments are expected to expire without being drawn upon, the total commitment amount does not necessarily represent future cash requirements. HBC evaluates each client's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by HBC upon the extension of credit, is based on management's credit evaluation of the borrower. Collateral held varies but may include cash, marketable securities, accounts receivable, inventory, property, plant and equipment, income-producing commercial properties, and/or residential properties. Fair value of these instruments is not material.

Standby letters of credit are written with conditional commitments issued by HBC to guaranty the performance of a client to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to clients. Fair value of these instruments is not material.

Claims

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

(15) Regulatory Matters

The Company and its subsidiary Banks are subject to various regulatory capital requirements administered by the federal 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. 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 the Company's and HBC's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Company's and HBC's 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 ensure capital adequacy require the Company and HBC to maintain minimum amounts and ratios (set forth in the table below) of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined). Management believes that, as of December 31, 2002, the Company and HBC meets all capital adequacy guidelines to which it is subject.

The most recent notification from the FDIC for HBC as of December 31, 2002 and 2001 categorized HBC, HBEB, HBSV, and BLA as "well capitalized" under the regulatory framework for prompt corrective action. To be categorized as "well capitalized" HBC must maintain minimum total risk-based, Tier I risk-based, and Tier I leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the Bank's category.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The Company's actual capital amounts and ratios are presented in the table.

	<u>Actual</u>		<u>For Capital Adequacy Purposes</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
	(Dollars in thousands)			
As of December 31, 2002				
Total Capital (to risk-weighted assets)	\$113,177	13.4%	\$67,568	(greater than or equal to) 8.0%
Tier 1 Capital (to risk-weighted assets) . . .	\$102,614	12.2%	\$33,645	(greater than or equal to) 4.0%
Tier 1 Capital (to average assets)	\$102,614	10.8%	\$38,005	(greater than or equal to) 4.0%
As of December 31, 2001				
Total Capital (to risk-weighted assets)	\$101,262	13.0%	\$62,315	(greater than or equal to) 8.0%
Tier 1 Capital (to risk-weighted assets) . . .	\$ 91,598	11.8%	\$31,162	(greater than or equal to) 4.0%
Tier 1 Capital (to average assets)	\$ 91,598	10.2%	\$35,921	(greater than or equal to) 4.0%

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

	<u>Actual</u>		<u>For Capital Adequacy Purposes</u>		<u>To Be Well-Capitalized Under Prompt Corrective Action Provisions</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
	(Dollars in thousands)					
As of December 31, 2002						
Total Capital (to risk-weighted assets)	\$56,182	13.0%	\$34,574	(greater than or equal to) 8.0%	\$43,217	(greater than or equal to) 10.0%
Tier 1 Capital (to risk-weighted assets)	\$50,749	11.7%	\$17,350	(greater than or equal to) 4.0%	\$26,025	(greater than or equal to) 6.0%
Tier 1 Capital (to average assets)	\$50,749	10.6%	\$19,151	(greater than or equal to) 4.0%	\$23,938	(greater than or equal to) 5.0%
As of December 31, 2001						
Total Capital (to risk-weighted assets)	\$50,441	12.7%	\$31,749	(greater than or equal to) 8.0%	\$39,686	(greater than or equal to) 10.0%
Tier 1 Capital (to risk-weighted assets)	\$45,460	11.5%	\$15,881	(greater than or equal to) 4.0%	\$23,822	(greater than or equal to) 6.0%
Tier 1 Capital (to average assets)	\$45,460	9.7%	\$18,746	(greater than or equal to) 4.0%	\$23,433	(greater than or equal to) 5.0%

HBEB's actual capital amounts and ratios are also presented in the table.

	<u>Actual</u>		<u>For Capital Adequacy Purposes</u>		<u>To Be Well-Capitalized Under Prompt Corrective Action Provisions</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
	(Dollars in thousands)					
As of December 31, 2002						
Total Capital (to risk-weighted assets)	\$12,666	11.3%	\$8,967	(greater than or equal to) 8.0%	\$11,209	(greater than or equal to) 10.0%
Tier 1 Capital (to risk-weighted assets)	\$11,263	10.0%	\$4,505	(greater than or equal to) 4.0%	\$ 6,758	(greater than or equal to) 6.0%
Tier 1 Capital (to average assets)	\$11,263	7.9%	\$5,703	(greater than or equal to) 4.0%	\$ 7,128	(greater than or equal to) 5.0%
As of December 31, 2001						
Total Capital (to risk-weighted assets)	\$12,105	11.6%	\$8,377	(greater than or equal to) 8.0%	\$10,471	(greater than or equal to) 10.0%
Tier 1 Capital (to risk-weighted assets)	\$10,847	10.4%	\$4,188	(greater than or equal to) 4.0%	\$ 6,282	(greater than or equal to) 6.0%
Tier 1 Capital (to average assets)	\$10,847	8.4%	\$5,171	(greater than or equal to) 4.0%	\$ 6,464	(greater than or equal to) 5.0%

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

HBSV's actual capital amounts and ratios are also presented in the table.

	Actual		For Capital Adequacy Purposes		To Be Well-Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
(Dollars in thousands)						
As of December 31, 2002						
Total Capital (to risk-weighted assets)	\$ 7,628	11.6%	\$5,261	(greater than or equal to) 8.0%	\$ 6,576	(greater than or equal to) 10.0%
Tier 1 Capital (to risk-weighted assets)	\$ 6,803	10.3%	\$2,642	(greater than or equal to) 4.0%	\$ 3,963	(greater than or equal to) 6.0%
Tier 1 Capital (to average assets)	\$ 6,803	9.3%	\$2,926	(greater than or equal to) 4.0%	\$ 3,658	(greater than or equal to) 5.0%
As of December 31, 2001						
Total Capital (to risk-weighted assets)	\$ 7,462	13.0%	\$4,585	(greater than or equal to) 8.0%	\$ 5,731	(greater than or equal to) 10.0%
Tier 1 Capital (to risk-weighted assets)	\$ 6,745	11.8%	\$2,292	(greater than or equal to) 4.0%	\$ 3,438	(greater than or equal to) 6.0%
Tier 1 Capital (to average assets)	\$ 6,745	9.9%	\$2,731	(greater than or equal to) 4.0%	\$ 3,413	(greater than or equal to) 5.0%

BLA's actual capital amounts and ratios are also presented in the table.

	Actual		For Capital Adequacy Purposes		To Be Well-Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
(Dollars in thousands)						
As of December 31, 2002						
Total Capital (to risk-weighted assets)	\$28,259	11.8%	\$19,159	(greater than or equal to) 8.0%	\$23,948	(greater than or equal to) 10.0%
Tier 1 Capital (to risk-weighted assets)	\$25,270	10.6%	\$ 9,536	(greater than or equal to) 4.0%	\$14,304	(greater than or equal to) 6.0%
Tier 1 Capital (to average assets)	\$25,270	9.4%	\$10,753	(greater than or equal to) 4.0%	\$13,441	(greater than or equal to) 5.0%
As of December 31, 2001						
Total Capital (to risk-weighted assets)	\$25,068	11.0%	\$18,231	(greater than or equal to) 8.0%	\$22,789	(greater than or equal to) 10.0%
Tier 1 Capital (to risk-weighted assets)	\$22,359	9.8%	\$ 9,117	(greater than or equal to) 4.0%	\$13,675	(greater than or equal to) 6.0%
Tier 1 Capital (to average assets)	\$22,359	8.5%	\$10,485	(greater than or equal to) 4.0%	\$13,106	(greater than or equal to) 5.0%

The Company is required to maintain reserves with the Federal Reserve Bank of San Francisco. Reserve requirements are based on a percentage of certain deposits. As of December 31, 2002, the Company maintained reserves of \$8.3 million in the form of vault cash and balances at the Federal Reserve Bank of San Francisco, which satisfied the regulatory requirements.

Under California 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 therefor. The California Banking Law 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, 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. 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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Commissioner may order a bank to refrain from making such a proposed distribution. At December 31, 2002, the amount available for such dividend without prior written approval was approximately \$17,101,000 for HBC, zero for HBEB and HBSV, and \$7,524,000 for BLA. Similar restrictions apply to the amounts and sum of loans advances and other transfers of funds from HBC to the Company.

(16) Parent Company only Condensed Financial Information

The condensed financial statements of Heritage Commerce Corp (parent company only) follow:

Condensed Balance Sheets

	<u>December 31,</u> <u>2002</u>	<u>December 31,</u> <u>2001</u>
	(Amounts in thousands)	
Cash and cash equivalents	\$ 9,133	\$ 5,747
Investment in and advancements to subsidiaries	96,655	87,106
Other assets	<u>2,517</u>	<u>2,963</u>
Total	<u>\$108,305</u>	<u>\$95,816</u>
Liabilities	\$ 1,738	\$ 1,664
Amounts due to nonbank subsidiaries	23,702	19,578
Shareholders' equity	<u>82,865</u>	<u>74,574</u>
Total	<u>\$108,305</u>	<u>\$95,816</u>

Condensed Statements of Income and Comprehensive Income

	<u>For the Years Ended,</u>		
	<u>December 31,</u> <u>2002</u>	<u>December 31,</u> <u>2001</u>	<u>December 31,</u> <u>2000</u>
	(Amounts in thousands)		
Dividends from Bank subsidiaries	\$ —	\$ —	\$ 250
Interest income	95	141	243
Management and service fees	10,747	8,573	6,995
Other income	—	—	100
Interest expense	—	—	(2)
Other expenses	<u>(13,096)</u>	<u>(12,923)</u>	<u>(10,552)</u>
Loss before equity in net income of subsidiary banks . .	(2,254)	(4,209)	(2,966)
Equity in undistributed net income of subsidiaries . . .	8,692	9,897	7,218
Income tax benefit (expense)	739	1,580	1,177
Net income	7,177	7,268	5,429
Other comprehensive income	<u>693</u>	<u>506</u>	<u>1,769</u>
Comprehensive income	<u>\$ 7,870</u>	<u>\$ 7,774</u>	<u>\$ 7,198</u>

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Condensed Statements of Cash Flows

	For the Years Ended,		
	December 31, 2002	December 31, 2001	December 31, 2000
	(Amounts in thousands)		
Cash flows from operating activities:			
Net Income	\$ 7,177	\$ 7,268	\$ 5,429
Adjustments to reconcile net income to net cash provided by (used in) operations:			
Provision for deferred income taxes	(739)	(1,580)	(1,177)
Equity in undistributed losses of subsidiaries	(8,692)	(9,897)	(7,218)
Net change in other assets	(416)	84	(1,177)
Net change in other liabilities	<u>1,635</u>	<u>809</u>	<u>1,653</u>
Net cash used in by operating activities	(1,035)	(3,316)	(2,490)
Cash flows from investing activities:			
Other (dividends received from Bank subsidiaries) . .	—	—	(17,079)
Cash distributed to Bank subsidiaries	<u>—</u>	<u>(2,750)</u>	<u>—</u>
Net cash used in investing activities	—	(2,750)	(17,079)
Cash flows from financing activities:			
Proceeds from issuance of common stock	421	1,067	1,991
Proceeds from issuance of long-term debt	4,000	5,000	14,000
Repayments of other short-term borrowings	<u>—</u>	<u>—</u>	<u>(2,000)</u>
Net cash provided by financing activities	<u>4,421</u>	<u>6,067</u>	<u>13,991</u>
Net increase (decrease) in cash and cash equivalents	3,386	1	(5,578)
Cash and cash equivalents, beginning of year	<u>5,747</u>	<u>5,746</u>	<u>11,324</u>
Cash and cash equivalents, end of year	<u>\$ 9,133</u>	<u>\$ 5,747</u>	<u>\$ 5,746</u>

EXHIBIT INDEX

	<u>Filed Herewith</u>	<u>Incorporated by Reference to Form</u>			<u>Exhibit No.</u>
		<u>8-A Dated</u>	<u>10-Q Dated</u>	<u>10-K Dated</u>	
2.1	Agreement and Plan of Merger and Reorganization dated as of May 9, 2000 between Heritage Commerce Corp and Western Holdings Bancorp (incorporated by reference from Annex A of the registration statement on Form S-4, Registration No. 333-40384, filed with the Commission on June 29, 2000)				
3.1	Heritage Commerce Corp Restated Articles of Incorporation as Amended effective June 29, 2001		6-30-01		3.1
3.2	Heritage Commerce Corp Bylaws as amended to September 27, 2001		9-30-01		3.2
4.1	The indenture, dated as of March 23, 2000, between Heritage Commerce Corp, as Issuer, and the Bank of New York, as Trustee			4-6-01 (10-K/A Amendment No. 1)	4.1
4.2	Amended and restated Declaration of Trust, Heritage Capital Trust I, dated as of March 23, 2000			4-6-01 (10-K/A Amendment No. 1)	4.2
4.3	The indenture, date as of September 7, 2000, between Heritage Commerce Corp, as Issuer, and State Street Bank and Trust Company, of Connecticut, National Association, as Trustee			4-6-01 (10-K/A Amendment No. 1)	4.3
4.4	Amended and restated Declaration of Trust by and among State Street Bank and Trust Company of Connecticut, National Association, as Institutional Trustee, and Heritage Commerce Corp, as Sponsor			4-6-01 (10-K/A Amendment No. 1)	4.4
4.5	Heritage Commerce Corp Rights Agreement dated as of November 1, 2001, including Form of Right Certificate attached thereto as Exhibit B	11-15-01			4.5
4.6	The indenture, dated as of July 31, 2001, between Heritage Commerce Corp, as Issuer, and State Street Bank and Trust Company, of Connecticut, National Association, as Trustee			3/28/02	4.6