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

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**FORM 10-K**

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(MARK ONE)

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

For the fiscal year ended December 31, 2001

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

77-0469558

(State or Other Jurisdiction of Incorporation or Organization)

(I.R.S. Employer Identification Number)

**150 Almaden Boulevard**

**San Jose, California 95113**

(Address of Principal Executive Offices including Zip Code)

**(408) 947-6900**

(Registrant's Telephone Number, Including Area Code)

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

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

**COMMON STOCK (NO PAR VALUE)**  
**PREFERRED SHARE PURCHASE RIGHTS**

(Title of class)

**NASDAQ**

(Name of each exchange on which registered)

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.

The aggregate market value of the stock held by non-affiliates of the Registrant, based upon the closing price of its common stock on March 19, 2002 (\$8.20 per share), as reported on the Nasdaq National Market System, was approximately \$82.6 million.

As of March 19, 2002, there were 11,132,462 shares of the Registrant's common stock (no par value) outstanding.

#### DOCUMENTS INCORPORATED BY REFERENCE

<u>DOCUMENTS INCORPORATED</u>	<u>PARTS OF FORM 10-K INTO WHICH INCORPORATED</u>
Definitive proxy statement for the Company's 2002 Annual Meeting of Shareholders to be filed within 120 days of the end of the fiscal year ended December 31, 2001.	Part III

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# HERITAGE COMMERCE CORP

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## PART I

### ITEM 1 - BUSINESS

#### *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".

#### **New Branches and Subsidiaries**

The Company's primary strategy is to establish de novo banks, branches, or representative offices in contiguous geographic areas. By virtue of each subsidiary's local ownership, management, and decision making, the Company hopes to benefit from the continuing trend in the banking industry towards merger and consolidation. The Company's, as well as the Banks', business strategy and promotional activities emphasize service and responsiveness to local needs.

On February 9, 1998, HBC opened a full-service branch in the city of Fremont, California. On December 7, 1998, the Company received approval to open Heritage Bank East Bay ("HBEB" and together with HBC, the "Banks"), a de novo bank, in the city of Fremont, California. On that date, HBEB became a subsidiary of the Company and took control of HBC's existing branch in Fremont and Loan Production Office in San Ramon, California. HBEB moved their San Ramon office to city of Danville, California in September 1999.

On December 22, 1998, HBC received authorization from the California Department of Financial Institutions to open a full service branch in the city of Morgan Hill, California. HBC's Board of Directors saw this geographic expansion as a continuation into HBC's primary market area, Santa Clara County, since Morgan Hill has a high concentration of potential clients with banking service requirements similar to those of HBC's current client mix. HBC opened the branch on March 1, 1999.

On January 18, 2000, HBSV commenced business as a California state-chartered commercial bank and a subsidiary of the Company in the premises previously occupied by the Morgan Hill branch of HBC.

On October 1, 2000, the Company completed its merger with Western Holdings Bancorp, holding Company of Bank of Los Altos ("BLA"). Bank of Los Altos, a full service commercial bank with two branches in Los Altos and one in Mountain View now operates as a wholly owned subsidiary of Heritage Commerce Corp. Unless otherwise noted, the information contained herein has been restated on a historical basis to reflect the merger with Western Holdings Bancorp as a pooling of interests as if the Companies had been combined for all periods presented.

On June 6, 2001, Heritage Bank South Valley 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 14,300 deposit accounts at December 31, 2001.

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 issues VISA and MasterCard credit cards

through the Independent Bankers Association. 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 Boulevard, 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**

On July 25, 2001, the Boards of Directors of Heritage Commerce Corp and Heritage Bank South Valley appointed Lane S. Lawson to be President & CEO of Heritage Bank South Valley. Mr. Lawson assumed the role vacated by retiring President Larry Koch.

On August 20, 2001, the Boards of Directors of Heritage Commerce Corp and Heritage Bank of Commerce appointed John F. McGrath to be President and CEO of Heritage Bank of Commerce. Mr. McGrath assumed the HBC position held by Brad L. Smith, who continues to serve as Chairman and CEO of Heritage Commerce Corp.

### **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 accelerating pace of consolidation among financial services 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 services 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 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 which relate to the regulation of the Company and the Banks. 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 to regular examination by, the Federal Reserve Board (FRB). Historically the activities of bank holding companies such as the Company have been limited by the Bank Holding Company Act (BHCA) to banking, managing or controlling banks, furnishing services to or performing services for their subsidiaries, and other activities 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 recent expansion of the powers of certain bank holding companies, see Item 1 - "BUSINESS – Supervision and Regulation

- Financial Services Modernization Legislation" 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 subsidiaries 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 the Banks are insured by the Federal Deposit Insurance Corporation (FDIC), which currently insures deposits to a maximum of \$100,000 per depositor. For this protection, the Banks pay a semi-annual assessment and are subject to the rules and regulations of the FDIC pertaining to deposit insurance and other matters.

HBC, HBEB, HBSV, and BLA are California state-chartered banks and members of the Federal Reserve System. State banks chartered in California that are members of the Federal Reserve System are subject to regulation, supervision and regular examination by the Department and by the FRB. The regulations of the Department and the FRB govern most aspects of the Banks' business, including reporting requirements, activities, investments, loans, borrowings, certain check-clearing activities, branching, mergers and acquisitions, reserves against deposits, and other areas.

### **Financial Services Modernization Legislation**

The Gramm-Leach-Bliley Act of 1999 (the "Financial Services Modernization Act") became effective March 11, 2000. The Financial Services Modernization Act repeals the 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 Financial Services Modernization 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 FRB, 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 Financial Services Modernization 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 all of its insured depository institution subsidiaries are well-capitalized and well-managed. In addition, the FRB must also determine that each 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 Financial Services Modernization Act.

The Financial Services Modernization 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, 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 the 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 Financial Services Modernization Act provides that designated federal regulatory agencies, including the FDIC, the FRB, the OCC and the SEC, are to 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 FRB's rule, which establishes privacy standards to be followed by state member banks such as the Banks, 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 Financial Services Modernization 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, HBEB, HBSV, and BLA will be permitted to form subsidiaries to engage in the activities authorized by the Financial Services Modernization Act, to the same extent as a national bank. In order to form a financial subsidiary, a bank must be well-capitalized, and the bank would be subject to the same capital deduction, risk management and affiliate transaction rules as are applicable to national banks.

The Company and the Banks do not believe that the Financial Services Modernization Act has had or will have a material adverse effect on its operations in the near-term. However, to the extent that it permits banks, securities firms, and insurance companies to affiliate, the financial services industry may experience further consolidation. The Financial Services Modernization 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 and the Banks face from larger institutions and other types of companies offering financial products, many of which may have substantially more financial resources than the Company and the Banks.

## **Limitations on Dividends**

The Company's ability to pay cash dividends is dependent on dividends paid to it by the Banks. 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 the Banks. The Company has no present intention of paying cash dividends in the foreseeable future. The legal ability of the Banks 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 the Banks will pay dividends at any time. For restrictions applicable to the Banks, 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 most intangible assets. "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) 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, 2001:

	<b>December 31, 2001</b>			
	<b>Actual</b>		<b>For Capital Adequacy Purposes</b>	
	<b>Amount</b>	<b>Ratio</b>	<b>Amount</b>	<b>Ratio</b>
Total risk-based capital/risk-weighted assets	\$ 101,262,000	13.0%	\$ 62,315,000	(greater than or equal to) 8.0%
Tier 1 capital/risk-weighted assets	\$ 91,598,000	11.8%	\$ 31,162,000	(greater than or equal to) 4.0%
Tier 1 capital / average assets	\$ 91,598,000	10.2%	\$ 35,921,000	(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 based on the capital measures indicated below:

<b>Capital Category</b>	<b>Total Risk-Based Capital Ratio</b>	<b>Tier 1 Risk-Based Capital Ratio</b>	<b>Tier 1 Leverage Ratio</b>
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%

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, redemptions 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 indicates 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 levels 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):

<b><u>Capital Category</u></b>	<b><u>Group A</u></b>	<b><u>Group B</u></b>	<b><u>Group C</u></b>
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, 2001, 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, the Banks 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, 1999, 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 the Banks.

### **Prompt Corrective Action**

The FDIC has authority: (1) to request that an institution's primary 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 primary 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 primary regulatory agency has with respect to those entities.

An undercapitalized institution is required to submit an acceptable capital restoration plan to its primary 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 financial institutions such as the Banks, 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 banks, as well as the activities of their subsidiaries and affiliates, are governed 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. In a series of reductions during 2001, the FRB reduced short-term interest rates by an aggregate total of 475 basis points. This decrease in short-term interest rates immediately affected the rates applicable to the majority of the Company's loans. While the decrease in interest rates also lowered the cost of interest bearing deposits, which represent one of the Company's primary funding sources, these deposits tend to reprice more slowly than floating rate loans. The reduction in market rates of interest which took place during 2001, as well as any further reductions that may take place in the future, will continue to have a negative effect on the Company's net interest margin and net interest income. 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, the Banks are required to have an annual independent audit and to prepare all financial statements in accordance with generally accepted accounting principles. The Banks are 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, the Banks are 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, the Banks may incur additional compliance costs or be required to expend additional funds for investments in the local communities they serve.

### **USA PATRIOT Act**

The terrorist attacks in September, 2001, have impacted the financial services industry and have already led to federal legislation that attempts to address certain issues involving financial institutions. 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.

Treasury regulations implementing the due diligence requirements must be issued no later than April 24, 2002. Whether or not regulations are adopted, IMLAFATA becomes effective July 23, 2002. Additional regulations are to be adopted during 2002 to 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 will establish 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 Heritage's operations.

### **Other Pending and Proposed Legislation**

Other legislative and regulatory initiatives which could affect the Company, the Banks 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 Banks would be affected thereby.

## ***EMPLOYEES***

At December 31, 2001, the Company employed 227 persons, primarily on a full-time basis. 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 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. In a series of reductions during 2001, the Board of Governors of the Federal Reserve System reduced short-term interest rates by an aggregate total of 475 basis points. This decrease in short-term interest rates immediately affected the rates applicable to the majority of the Company's loans and investments. The decrease also impacted the Company's interest bearing liabilities, however, the timing of the repricing of the liabilities generally lagged the repricing of the loans and investments. Any further reductions that may take place in the future 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 Bay Area, California. A 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, the demand for the Company's products and services, which in turn may have a material adverse effect on the Company's result of operations. A downturn in the national economy might further exacerbate local economic conditions. During the past year, the availability of a sufficient supply of electrical power in California has been unreliable at times. In addition, recent events, including those of September 11, 2001, 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 extent of the future impact of these events on economic and business conditions can't be predicted.

### **Competition may adversely affect the Company's performance**

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 accelerating pace of consolidation among financial services 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 have those services provided in whole or in part by its correspondent banks.

## ITEM 2 - PROPERTIES

Heritage Bank of Commerce's main and executive offices and Heritage Commerce Corp's offices are located at 150 Almaden Boulevard in San Jose, California 95113 and at 101 Park Center Plaza Suite 300, in San Jose, California 95113. Heritage Bank East Bay's main office is located at 3077 Stevenson Boulevard in Fremont, California 94538 with a branch office located at 310 Hartz Road in Danville California 94526. Heritage Bank South Valley's main office is located at 18625 Sutter Boulevard in Morgan Hill with a branch office at 737 First Street in Gilroy, California 95020. Bank of Los Altos's main office 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 El Camino Real in Mountain View, California 94040.

The main office at 150 Almaden Boulevard, San Jose, California, is leased under a non-cancelable operating lease with a non-affiliated third party with terms, including renewal options, ranging from 5 to 14 years. The primary operating area consists of approximately 13,500 square feet of space comprising the entire usable ground floor and a portion of the second floor of a 15-story class-A office building in downtown San Jose. This space also serves as the main office of HBC. The lease arrangement for the primary operating area is a "partial gross lease" for 15 years commencing June 8, 1996 and expiring February 28, 2010. The monthly rent under the lease for the first five-year term is \$21,482. During the second five-year term the monthly rent increases to \$25,535 and will increase to 95 percent of fair rental value starting from year eleven until the term expires. Provisions of the lease include the right to early termination after 120 months.

In addition, the Company leased approximately 1,255 square feet of space contiguous to the primary operating area for meetings, staff training and marketing events. The lease for this additional space commenced January 1, 1997 and expired December 31, 2001. The lease was extended in January 1, 2002 until June 30, 2002 on the same terms and conditions in effect under the original lease other than the monthly base rent which was increased to \$4,516.

In August 1997, the Company leased an area on the second floor of Heritage's main office containing approximately 2,175 square feet of space. The monthly rent was \$4,024 until May 31, 2001. From June 1, 2001 to May 31, 2006, the monthly rent increased to \$4,785. The rent for the period from June 1, 2006 until the end of the lease will be 95 percent of fair rental value at that time. The lease for this additional space is coterminous with the original lease.

In June 1998, the Company leased space at 100 Park Center Plaza, Suite 300, consisting of approximately 5,623 square feet of space. The rent started at \$11,527 for the first year and escalates to \$12,651 for the last year of the lease. The lease will terminate on May 31, 2003.

In February 1998, Heritage leased space for HBEB's primary office at 3077 Stevenson Blvd., Fremont, California, consisting of 6,590 square feet of space in a stand-alone office building. The lease, which commenced February 1, 1998, is for a ten-year period expiring January 2008. The rent for the first twelve-month period is \$13,180 per month, and the rent increases annually thereafter by 4%.

In March 1999, the Company entered into an agreement to lease 7,260 square feet of office space for HBSV's primary office in a one-story building consisting of 26,353 square feet, located at 18625 Sutter Boulevard in Morgan Hill, California. The commencement date of the lease was November 1, 1999 with monthly rent payments beginning at \$11,447, subject to adjustments every 36 months thereafter based on the percentage increase in the consumer price index as defined in the lease agreement. The term of the lease is 15 years, expiring on October 31, 2014.

In September 1999, the Company entered into an agreement to sublease approximately 2,700 square feet of office space in a one-story multi-tenant building located at 310 Hartz Avenue in Danville, California in order to relocate HBEB's San Ramon office. The commencement date of the sublease was September 15, 1999, with monthly rent payments beginning at \$7,025, subject to annual increases of 4%. The term of the sublease is approximately 7 1/2 years, expiring on December 31, 2007.

In April 2000, the Company leased the third floor of 150 Almaden Boulevard, San Jose, California consisting of 12,824 square feet. The lease will expire on February 28, 2010, coterminous with the lease for the main office. Rent payments, which will begin in October of 2000, will be \$42,319 per months subject to annual increase of 3%.

In August 2000, the Company leased space at 740 Front Street, Santa Cruz, California, consisting of 2,176 square feet. The lease, which commenced August 1, 2000, is for a five-year period, expiring July 31, 2005. The rent payments will be \$4,026 per month, subject to annual increase of 8%.

In January 2001, the Company leased space for HBSV's Gilroy branch at 737 First Street, Gilroy, California, consisting of 2,200 square feet. The lease, which commenced January 1, 2001, is for a five-year period, expiring December 31, 2006, with an option to extend five more years. The rent payments for the first twelve-month period is \$3,300 per month and it will increase annually thereafter with a minimum of 3% per annum and a maximum of 8% per annum.

In February 2002 Heritage Bank of Commerce renewed its lease for a loan production office located at 8788 Elk Grove Boulevard Building 3 in Elk Grove California 95624. The lease covers approximately 224 square feet and expires on January 31, 2003. The monthly rent payment for the space is \$549.

In May 2001 Heritage Bank of Commerce renewed its lease for a loan production office located at 23 E. Beach Street Suite 212 in Watsonville, California 95076. The lease covers approximately 147 square feet and expires on April 30, 2002. The monthly rent payment for the space is \$254.

In July 2001 Heritage Bank of Commerce entered into an agreement to lease space in an office building located at 4-C Williamsburg Lane in Chico, California 95926 to be used as a loan production office. The lease covers approximately 275 square feet and expires on June 30, 2002. The monthly rent payment for the space is \$275.

In October 2001 Heritage Bank of Commerce renewed its lease for a loan production office located at 285 W. Shaw Avenue Suite 204 in Fresno, California 93704. The lease covers approximately 336 square feet and expires on September 30, 2002. The monthly rent payment for the space is \$436.

The main office for Bank of Los Altos is located at 4546 El Camino Real, Los Altos, California. The Bank executed the lease of approximately 7,900 square feet of space in April 1995, to expire in April 2005, with options to renew at that time. The lease calls for annual consumer price index adjustments between 2% and 5%. Current monthly rent at this facility is \$14,296.

The San Antonio branch of BLA is located at 369 S. San Antonio Road, Los Altos, California. The lease covers approximately 3,500 square feet and has a ten year term from October 1998 through September 2008, with options to renew available at that time. Current monthly rent is \$13,665 and increases 4% each year.

The Mountain View branch of BLA is located at 175 El Camino Real, Mountain View, California. The lease is for approximately 4,800 square feet and has a ten year term from August 1998 through July 2008, with options to renew available at that time. The lease calls for annual consumer price index adjustments between 3% and 6%. Current monthly rent is \$13,185.

For additional information on operating leases and rent expense, refer to Note 10 of the Company's Consolidated Financial Statements, beginning on page 54 of this Report on Form 10-K.

### **ITEM 3 - LEGAL PROCEEDINGS**

In 1992 and for a period prior thereto, a former officer and director of Bank of Los Altos served as a director of Pacific National Financial Company (PNFC), a Canadian corporation, when a PNFC subsidiary was Bank of Los Altos's parent company. In December 1998, Bank of Los Altos received a request for indemnity from the former officer under an indemnity agreement entered into by Bank of Los Altos in December 1992. The request for indemnity relates to three complaints filed in July 1998 naming the former officer and seven other former directors of PNFC and seeks damages of \$166 million (\$Canadian 240 million) arising from their role as PNFC directors. The largest of the three actions alleges that the defendants breached their fiduciary duties to PNFC, resulting in its 1992 bankruptcy. The former officer has requested that Bank of Los Altos pay for his defense and indemnify him in connection with such actions. Although Bank of Los Altos has reserved its rights under the indemnity agreement, it has conditionally agreed to be responsible for payment of the former officer's defense costs. Following service of the complaints in December, 1998, Bank of Los Altos has been informed by counsel that there has been no effort to prosecute the cases by the plaintiffs or any communications from plaintiffs stating an intent to proceed with the

litigation. Based on the representations of the former officer and discussions with legal counsel, management and the Board of Directors of the Company and Bank of Los Altos have no reason to believe that the indemnification will result in any material effect on the financial statements of the Company.

In addition to the above, the Company is involved in a number of 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.

#### **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, 2001.

## **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 2001 and 2000 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, 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
Year ended December 31, 2000:		
Fourth quarter	\$ 10.25	\$ 8.75
Third quarter	\$ 11.34	\$ 10.14
Second quarter	\$ 11.66	\$ 9.98
First quarter	\$ 13.40	\$ 10.83

As of March 19, 2002, there were approximately 1,100 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 Commissioner of the Department of Financial Institutions ("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 Commissioner may order a bank to refrain from making such a proposed distribution.

The FDIC and the Commissioner 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 Commissioner 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 3 for 2 stock split on February 19, 1999 and a 10% stock dividend on February 21, 2000. All share and per share information has been retroactively adjusted for all stock splits and stock dividends.

## ***MANDATORILY REDEEMABLE CUMULATIVE TRUST PREFERRED SECURITIES OF SUBSIDIARY GRANTOR TRUST***

The Company has three special purpose entities "SPE's" which are consolidated into the Company's financial statements and were formed for the exclusive purpose of raising capital through the issuance of Mandatorily Redeemable Trust Preferred Securities. For financial reporting purposes, the Subordinated Debentures and related trust investments in the Subordinated Debentures have been eliminated in consolidation and the Trust Preferred Securities are included in the consolidated balance sheet. Under applicable regulatory guidelines all of the Trust Preferred Securities currently qualify as Tier I capital.

### **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 7/8 % 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 Capital 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 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%), the current interest rate is 5.75%, 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 5.75%); 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.

## ITEM 6 – SELECTED FINANCIAL DATA

The following table presents a summary of selected financial data 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

(Dollars in thousands, except per share amounts and ratios)	AT AND FOR YEAR ENDED DECEMBER 31,				
	2001	2000	1999	1998	1997
<b>INCOME STATEMENT DATA:</b>					
Interest income.....	\$ 65,370	\$ 67,921	\$ 45,418	\$ 38,193	\$ 24,533
Interest expense.....	24,366	25,101	15,398	12,048	7,071
Net interest income before provision					
for probable loan losses.....	41,004	42,820	30,020	26,145	17,462
Provision for probable loan losses.....	1,910	3,159	2,198	1,806	1,330
Net interest income after provision					
for probable loan losses.....	39,094	39,661	27,822	24,339	16,132
Noninterest income.....	5,932	2,877	6,051	3,178	2,129
Noninterest expenses.....	33,348	34,060	26,598	21,744	14,202
Income before income taxes.....	11,678	8,478	7,275	5,773	4,059
Provision for income taxes.....	4,410	3,049	2,606	2,267	1,224
Net income.....	\$ 7,268	\$ 5,429	\$ 4,669	\$ 3,506	\$ 2,835
<b>PER SHARE DATA(1):</b>					
Basic net income(2).....	\$ 0.66	\$ 0.51	\$ 0.47	\$ 0.39	\$ 0.34
Diluted net income(3).....	\$ 0.64	\$ 0.49	\$ 0.43	\$ 0.35	\$ 0.31
Book value(4).....	\$ 6.71	\$ 6.01	\$ 5.81	\$ 4.45	\$ 3.74
Weighted average number of shares					
outstanding - basic.....	11,082,157	10,607,584	9,885,036	8,990,769	8,399,174
Weighted average number of shares					
outstanding - diluted.....	11,379,721	11,108,329	10,922,977	9,916,907	9,185,147
Shares outstanding at period end.....	11,114,967	10,939,124	9,737,739	9,433,773	8,406,121
<b>BALANCE SHEET DATA:</b>					
Investment securities.....	\$ 106,810	\$ 110,802	\$ 74,819	\$ 127,217	\$ 118,988
Net loans.....	621,763	601,130	394,729	332,862	194,076
Allowance for probable loan losses.....	11,154	9,651	6,511	5,069	3,270
Total assets.....	912,730	846,224	677,233	581,404	394,122
Total deposits.....	807,908	738,186	601,420	509,916	355,728
Other borrowed funds.....	--	18,000	12,000	22,500	3,500
Trust preferred securities.....	19,000	14,000	--	--	--
Total shareholders' equity.....	74,574	65,733	56,544	41,991	31,474
<b>SELECTED PERFORMANCE RATIOS:</b>					
Return on average assets(5).....	0.84 %	0.70 %	0.79 %	0.74 %	0.91 %
Return on average equity.....	10.23 %	9.07 %	9.68 %	9.60 %	9.58 %
Net interest margin.....	5.04 %	5.95 %	5.56 %	6.03 %	6.10 %
Efficiency.....	71.05 %	74.53 %	73.74 %	74.15 %	72.49 %
Average net loans as a percentage					
of average deposits.....	78.21 %	75.44 %	71.88 %	62.35 %	58.28 %
Average total shareholders' equity as a					
percentage of average total assets.....	8.18 %	7.69 %	8.15 %	7.68 %	9.46 %
<b>SELECTED ASSET QUALITY RATIOS(6):</b>					
Net loan charge-offs to average loans.....	0.07 %	-- %	0.20 %	-- %	0.14 %
Allowance for loan losses to total loans.....	1.76 %	1.58 %	1.62 %	1.50 %	1.66 %
<b>CAPITAL RATIOS(7):</b>					
Tier 1 risk-based.....	11.8 %	10.5 %	11.3 %	9.4 %	13.4 %
Total risk-based.....	13.0 %	11.7 %	12.5 %	10.5 %	14.7 %
Leverage.....	10.2 %	9.3 %	8.5 %	7.3 %	8.3 %

## Notes:

- 1) All share figures are adjusted to reflect (i) a 10% stock dividend paid to shareholders of record as of February 5, 1996; (ii) a 5% stock dividend paid to shareholders of record as of February 5, 1997; (iii) a 3-for-2 stock split paid to shareholders of record as of August 1, 1997; (iv) a 3-for-2 stock split paid to shareholders of record as of February 5, 1999; (v) 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, restructured loans, and other real estate owned. 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. As of December 31, 1997, the Company had no 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.

### Critical Accounting Policies

#### General

Heritage Commerce Corp'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, the Company uses the 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 the Company's financial results. The Company used historical loss factors as one factor in determining the inherent loss that may be present in the Company's loan portfolio. Actual losses could differ significantly from the historical factors that we use. Other estimates that the Company used are related to the expected useful lives of the Company's depreciable assets. In addition GAAP itself may change from one previously acceptable method to another method. Although the economics of the Company's transactions would be the same, the timing of events that would impact the Company's transactions could change.

#### *Allowance for Loan Losses*

The allowance for loan losses is an estimate of the losses that may be sustained in the Company's 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 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 could differ from the loss incurred in the future. However, since this history is updated with the most recent loss information, the errors that might otherwise occur are mitigated. 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 be greater or less than 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 within this section on page 37.

### *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, 2001, 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.

## **RESULTS OF OPERATIONS**

### **OVERVIEW**

For the year ended December 31, 2001, consolidated net income was \$7,268,000, or \$0.64 per diluted share compared to \$5,429,000, or \$0.49 per diluted share and \$4,669,000, or \$0.43 per diluted share for the years ended December 31, 2000 and 1999, respectively. 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. The increase in 2000 over 1999 was primarily attributable to the mix and the growth in earning assets funded by new deposits at favorable rates as well as the improvements in the Company's mix of earning assets in favor of higher yielding assets, such as loans.

Average interest earning assets for 2001 were up 13% over 2000. The increase was primarily attributable to growth in loans, which had higher yields than other interest earning assets. The average rate on interest earning assets decreased to 8.04% in 2001 from 9.43% in 2000 and 8.40% in 1999 as a result of the decline in the short term interest rates in 2001, reflecting the FRB's eleven reductions in short term interest rates totaling 475 basis points. Average interest bearing liabilities for 2001 were up 12% over 2000, with the increase primarily attributable to growth in interest bearing demand deposits, and time and brokered deposits. The Company's average rate paid on interest bearing liabilities decreased to 4.12% in 2001 from 4.75% in 2000, reflective of the declining interest rate environment in 2001 and the timing of the Company's repricing of its interest bearing deposits, and was 3.88% in 1999. As a result, net interest margin decreased to 5.04% in 2001, compared to 5.95% in 2000 and 5.56% in 1999.

Total noninterest income was \$5,932,000 in 2001, compared to \$2,877,000 in 2000, and \$6,051,000 in 1999. The primary components of noninterest income in 2001 included \$1,758,000 in gains on sales of SBA loans, \$732,000 in gains on sales of securities, \$1,029,000 in other investments, primarily due to the increase in the cash surrender value of Corporate Owned Life Insurance and \$967,000 in service charges and other fees. Noninterest income in 2000 included \$716,000 in service charges and other fees, and the \$778,000 increase in the cash surrender value of Corporate Owned Life Insurance. Noninterest income in 1999 included \$560,000 in service charges and fees, \$429,000 in other investment income, servicing income of \$1,903,000, primarily from \$1,576,000 in revenue from the origination of credit cards for an unaffiliated financial institution, and a \$969,000 gain on sale of securities. The credit card origination agreement terminated in 1999 and was not renewed. The Company, as a policyholder of a life assurance company, received a one-time pre-tax gain of \$530,000 in 1999 as a result of the demutualization of that

company.

Total noninterest expense was \$33,348,000 in 2001, compared to \$34,060,000 in 2000, and \$26,598,000 in 1999. The decrease in pretax merger-related expenses for the merger with Western Holdings Bancorp of \$3,164,000 in 2001 as compared to 2000, was offset by increases in salaries and benefits of \$1,993,000, increase in occupancy and equipment expenses of \$572,000, and increase in advertising and promotion expenses, loan origination costs, stationery and supplies in support of the overall growth in the Company. The increase in 2000 over 1999 was primarily in salaries and benefits, up \$2,293,000, as a result of the payment of severance costs related to a change in management and an increase in the number of employees to support the growth of the Company.

Total assets as of December 31, 2001 were \$912,730,000, an increase of \$66,506,000, or 8%, from \$846,224,000 as of December 31, 2000. Total deposits as of December 31, 2001 were \$807,908,000, an increase of \$69,722,000, or 9%, from \$738,186,000 as of December 31, 2000.

Total portfolio loans as of December 31, 2001 were \$632,917,000, an increase of \$22,136,000, or 4%, compared to \$610,781,000 as of December 31, 2000. The Company's allowance for probable loan losses was \$11,154,000, or 1.76%, of total loans as of December 31, 2001, compared to \$9,651,000, or 1.58%, of total loans at December 31, 2000.

Nonperforming assets include nonaccrual loans, loans past due 90 days or more and still accruing, troubled debt restructuring and other real estate owned. As of December 31, 2001 and 2000, the Company had no nonperforming assets. As of December 31, 1999, nonperforming assets were \$1,402,000.

The Company's shareholders' equity at December 31, 2001 was \$74,574,000 compared with \$65,733,000 as of December 31, 2000, a 13% increase, which reflects net earnings of \$7,268,000 in 2001, the proceeds from exercise of stock options and the increase in the unrealized gain on securities available-for-sale. Book value per share increased 12% to \$6.71 as of December 31, 2001, compared to \$6.01 as of December 31, 2000. The Company's leverage capital ratio increased to 10.2% at December 31, 2001, from 9.3% at December 31, 2000 and 8.5% at December 31, 1999, primarily due to the growth in the shareholders' equity and the additional Tier I capital from the \$5.0 million of trust preferred securities issued in 2001.

Return on average equity for the year ended December 31, 2001 was 10.23%, compared to 9.07% for 2000 and 9.68% for 1999. The increase in 2001 over 2000 was the result of the increase in earnings. The decrease in 2000 from 1999 was primarily due to the effect of the \$2.0 million in merger-related costs, net of tax. Return on average assets in 2001 increased to 0.84% from 0.70% in 2000. Return on average assets was 0.79% in 1999.

## 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,								
	2001			2000			1999		
	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)									
<b>ASSETS:</b>									
Loans, gross(1).....	\$ 645,632	\$ 57,518	8.91%	\$ 537,317	\$ 56,709	10.55%	\$ 380,686	\$ 36,742	9.66%
Investment securities(2).....	96,340	5,269	5.47%	101,211	6,188	6.12%	93,271	5,305	5.69%
Interest bearing deposits in banks.....	5,094	157	3.08%	1,330	66	4.97%	--	--	--
Federal funds sold.....	66,490	2,426	3.65%	80,073	4,958	6.19%	66,937	3,371	5.04%
Total interest earning assets.....	813,556	65,370	8.04%	719,931	67,921	9.43%	540,894	45,418	8.40%
Cash and due from banks.....	28,795			35,429			25,520		
Premises and equipment, net.....	6,024			6,803			6,723		
Other assets.....	20,249			17,026			18,864		
Total assets.....	\$ 868,624			\$ 779,189			\$ 592,001		
<b>LIABILITIES AND SHAREHOLDERS'</b>									
<b>EQUITY:</b>									
Deposits:									
Demand, interest bearing.....	\$ 69,634	\$ 1,099	1.58%	\$ 55,616	\$ 1,014	1.82%	\$ 39,996	\$ 717	1.79%
Savings and money-market.....	227,344	7,014	3.09%	228,336	9,496	4.16%	186,112	6,107	3.28%
Time deposits, under \$100.....	78,910	4,237	5.37%	73,058	4,273	5.85%	58,423	2,969	5.08%
Time deposits, \$100 and over.....	166,268	8,606	5.18%	151,275	8,701	5.75%	86,963	4,201	4.83%
Brokered deposits.....	30,843	1,641	5.32%	10,544	690	6.55%	8,812	508	5.76%
Other borrowings.....	18,545	1,769	9.54%	9,617	927	9.64%	16,893	896	5.30%
Total interest bearing liabilities.....	591,544	24,366	4.12%	528,446	25,101	4.75%	397,199	15,398	3.88%
Demand deposits.....	204,114			183,422			141,250		
Other liabilities.....	1,910			7,433			5,295		
Total liabilities.....	797,568			719,301			543,744		
Shareholders' equity.....	71,056			59,888			48,257		
Total liabilities and shareholders' equity.....	\$ 868,624			\$ 779,189			\$ 592,001		
Net interest income / margin.....		\$ 41,004	5.04%	\$ 42,820		5.95%	\$ 30,020		5.56%

(1) Yields and amounts earned on loans include loan fees of \$4,532,000, \$4,065,000 and \$2,819,000 for the years ended December 31, 2001, 2000 and 1999. Nonaccrual loans of zero for the years ended December 31, 2001 and 2000, and \$1,402,000 for the year ended December 31, 1999 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, 2001 decreased \$1,816,000, or 4.2%, to \$41,004,000, compared to \$42,820,000 reported for 2000. Net interest income for 2000 increased \$12,800,000, or 43%, from \$30,020,000 reported for 1999. The decrease in 2001 from 2000 occurred primarily as a result of the reductions in short term interest rates during 2001. This decrease in short term interest rates 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 2000 was mitigated by the overall increase in volume of the loan portfolios which contributed \$5,769,000 to net interest income, however the decline in overall rates resulted in a decrease in net interest income of \$7,585,000. The Company's average interest earning assets were up \$93,625,000, or 13%, in 2001 to \$813,556,000 from \$719,931,000 for 2000.

The Company's average interest bearing liabilities were up \$63,098,000, or 12%, in 2001 to \$591,544,000 from \$528,446,000 for 2000. The increase in 2000 over 1999 net interest income was primarily a result of the growth that occurred in earning assets augmented by the overall increase in yields, funded by the increases in deposits. The Company's average interest earning assets were up \$179,037,000, or 33%, in 2000 from the average of \$540,894,000 for 1999. The net yield on interest earning assets in 2001 was 8.04%, compared to 9.43% in 2000, and 8.40% in 1999.

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.

	<u>2001 versus 2000</u>			<u>2000 versus 1999</u>		
	<u>Increase (Decrease) Due</u>			<u>Increase (Decrease) Due</u>		
	<u>to Change In:</u>			<u>to Change In:</u>		
	<u>Average</u>	<u>Average</u>	<u>Net</u>	<u>Average</u>	<u>Average</u>	<u>Net</u>
(Dollars in thousands)	<u>Volume</u>	<u>Rate</u>	<u>Change</u>	<u>Volume</u>	<u>Rate</u>	<u>Change</u>
<b>INTEREST EARNING ASSETS:</b>						
Loans, gross.....	\$ 9,650	\$ (8,841)	\$ 809	\$ 16,531	\$ 3,436	\$ 19,967
Investment securities.....	(266)	(653)	(919)	499	384	883
Interest bearing deposits in banks	116	(25)	91	66	--	66
Federal funds sold.....	(496)	(2,036)	(2,532)	813	774	1,587
Total interest earning assets.....	<u>\$ 9,004</u>	<u>\$ (11,555)</u>	<u>\$ (2,551)</u>	<u>\$ 17,909</u>	<u>\$ 4,594</u>	<u>\$ 22,503</u>
<b>INTEREST BEARING LIABILITIES:</b>						
Demand, interest bearing.....	\$ 221	\$ (136)	\$ 85	\$ 285	\$ 12	\$ 297
Savings and money-market.....	(31)	(2,451)	(2,482)	1,756	1,633	3,389
Time deposits, under \$100.....	314	(350)	(36)	856	447	1,303
Time deposits, \$100 and over.....	776	(871)	(95)	3,699	802	4,501
Brokered deposits.....	1,080	(129)	951	113	69	182
Other borrowings.....	875	(33)	842	(702)	733	31
Total interest bearing liabilities.....	<u>\$ 3,235</u>	<u>\$ (3,970)</u>	<u>\$ (735)</u>	<u>\$ 6,007</u>	<u>\$ 3,696</u>	<u>\$ 9,703</u>
Net interest income.....	<u>\$ 5,769</u>	<u>\$ (7,585)</u>	<u>\$ (1,816)</u>	<u>\$ 11,902</u>	<u>\$ 898</u>	<u>\$ 12,800</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 2001, the provision for probable loan losses was \$1,910,000, compared to \$3,159,000 for 2000 and \$2,198,000 for 1999. The allowance for probable loan losses represented 1.76%, 1.58%, and 1.62% of total loans at December 31, 2001, 2000, and 1999, respectively. See "Allowance for Probable Loan Losses" on page 37 for additional information.

## NONINTEREST INCOME

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

(Dollars in thousands)	Years Ended December 31,			2001 versus 2000		2000 versus 1999	
	2001	2000	1999	Amount	Percent	Amount	Percent
Gain on sale of loans.....	\$ 1,758	\$ --	\$ 262	\$ 1,758	-- %	\$ (262)	(100)%
Other investments.....	1,029	778	429	251	32 %	349	81 %
Service charges and other fees.....	967	716	560	251	35 %	156	28 %
Gain on sale of securities							
available-for-sale.....	732	44	969	688	1,564 %	(925)	(95)%
Servicing income.....	356	236	1,903	120	51 %	(1,667)	(88)%
Gain on sale of Internet credit							
card portfolio.....	--	60	289	(60)	(100)%	(229)	(79)%
Gain on sale of shares of							
demutualized life assurance							
company.....	--	47	530	(47)	(100)%	(483)	(91)%
Gain on sale of deposits.....	--	16	240	(16)	(100)%	(224)	(93)%
Other income.....	1,090	980	869	110	11 %	111	13 %
Total.....	\$ 5,932	\$ 2,877	\$ 6,051	\$ 3,055	106 %	\$ (3,174)	(52)%

Noninterest income for the year ended December 31, 2001 was \$5,932,000, compared to \$2,877,000 for 2000 and \$6,051,000 for 1999. The increase in 2001 was primarily due to increased sales of SBA loans resulting in gains of \$1,758,000 and to an increase in gains on sales of securities in the amount of \$688,000, compared to the same period in 2000. The increased sales of SBA loans were attributable to the strategic focus in 2001 on increasing SBA origination and to take advantage of the favorable market conditions for sales of the guaranteed portions. The interest rate environment in 2001 provided the opportunity for the Company to realize gains on the sale of loans and securities. The increases in service charges and fees of \$251,000, was primarily the result of an increase in activity resulting from the growth of the Company. The increases in other investment income of \$251,000 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. The decrease in 2000 from 1999 was primarily due to \$1,576,000 in servicing income from the origination of credit cards for an unaffiliated financial institution in 1999, which was terminated in 1999, and a \$969,000 gain on sale of securities available-for-sale recognized in 1999, compared to a \$44,000 gain on sale of securities available-for-sale recognized in 2000. The decrease in gain on sale of loans of \$262,000 was primarily due to the decrease in the level of sales of SBA loans in 2000, compared to 1999. The Company also received a one-time pre-tax gain of \$530,000 in 1999 as a result of the demutualization of a life assurance company compared to a \$47,000 gain in 2000. The increase in other investment income in 2000 of \$349,000 was primarily due to the increase 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:

(Dollars in thousands)	Years Ended December 31,			2001 versus 2000		2000 versus 1999	
	2001	2000	1999	Amount	Percent	Amount	Percent
Salaries and benefits.....	\$ 18,120	\$ 16,127	\$ 13,834	\$ 1,993	12 %	\$ 2,293	17 %
Occupancy.....	2,847	2,399	2,034	448	19 %	365	18 %
Client services.....	1,889	1,839	1,527	50	3 %	312	20 %
Furniture and equipment.....	1,453	1,329	1,350	124	9 %	(21)	(2)%
Professional fees.....	1,447	1,861	1,659	(414)	(22)%	202	12 %
Loan origination costs.....	1,335	1,011	539	324	32 %	472	88 %
Advertising and promotion.....	1,116	1,029	1,113	87	8 %	(84)	(8)%
Stationery & supplies.....	489	388	300	101	26 %	88	29 %
Telephone .....	358	359	208	(1)	(0)%	151	73 %
Merger-related costs.....	--	3,164	--	(3,164)	(100)%	3,164	-- %
Other.....	4,294	4,554	4,034	(260)	(6)%	520	13 %
Total.....	\$ 33,348	\$ 34,060	\$ 26,598	\$ (712)	(2)%	\$ 7,462	28 %

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

	2001		2000		1999	
	Amount	% of	Amount	% of	Amount	% of
		Total		Total		Total
Salaries and benefits.....	\$ 18,120	54 %	\$ 16,127	47 %	\$ 13,834	52 %
Occupancy.....	2,847	9 %	2,399	7 %	2,034	8 %
Client services.....	1,889	6 %	1,839	5 %	1,527	6 %
Furniture and equipment.....	1,453	4 %	1,329	4 %	1,350	5 %
Professional fees.....	1,447	4 %	1,861	5 %	1,659	6 %
Loan origination costs.....	1,335	4 %	1,011	3 %	539	2 %
Advertising and promotion.....	1,116	3 %	1,029	3 %	1,113	4 %
Stationery & supplies.....	489	1 %	388	1 %	300	1 %
Telephone.....	358	1 %	359	1 %	208	1 %
Merger-related costs.....	--	--	3,164	9 %	--	--
Other.....	4,294	14 %	4,554	15 %	4,034	15 %
Total.....	\$ 33,348	100 %	\$ 34,060	100 %	\$ 26,598	100 %

Noninterest expenses for the year ended December 31, 2001 were \$33,348,000, a decrease of \$712,000, or 2%, from \$34,060,000 for the year ended December 31, 2000, which was up \$7,462,000, or 28%, from \$26,598,000 for the year ended December 31, 1999.

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 Company employed 227 people at December 31, 2001, up 11 from 216 employees at December 31, 2000 and 203 employees at December 31, 1999. There was an increase in occupancy and equipment expenses of \$572,000 and increases in advertising and promotion expenses of \$87,000, loan origination costs of \$324,000, stationery and supplies of \$101,000 in support of the overall growth of the Company and the addition of new facilities. In 2001, professional fees decreased \$414,000 as a result of certain projects completed in 2000, which were not necessary in 2001. The increase in 2000 over 1999 was primarily in salaries and benefits, up \$2,293,000, as a result of the payment of severance costs related to a change in management and an increase in the number of employees. The increase in occupancy expenses, professional fees and client services in 2000 were to support the growth of the Company.

## 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 \$4,410,000, \$3,049,000, \$2,606,000 for the years ended December 31, 2001, 2000, and 1999, respectively. The Company's effective tax rates were 37.8%, 36.0%, and 35.8% for the years ended December 31, 2001, 2000, and 1999, 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 and changes in the level of investments in municipal securities in 2001.

## FINANCIAL CONDITION

At December 31, 2001, the Company's total assets were \$912,730,000, an increase of 8% from \$846,224,000 at December 31, 2000. Total portfolio loans were \$632,917,000, an increase of 4% from December 31, 2000, and total deposits were \$807,908,000, an increase of 9% from December 31, 2000. The above reflects the continued strong internal growth of the Company.

## SECURITIES PORTFOLIO

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

(Dollars in thousands)	Years Ended December 31,		
	2001	2000	1999
<b>Securities available-for-sale (at fair value)</b>			
U.S. Treasury.....	\$ 3,593	\$ 8,524	\$ 11,501
U.S. Government Agencies.....	53,762	48,202	21,466
Mortgage-backed securities.....	22,839	18,870	10,001
Municipals - tax exempt.....	9,273	14,297	7,877
Corporate bonds.....	2,067	--	--
Other debt securities.....	--	1,001	977
Total securities available-for-sale.....	<u>\$ 91,534</u>	<u>\$ 90,894</u>	<u>\$ 51,822</u>
<b>Securities held-to-maturity (at amortized cost)</b>			
Mortgage-backed securities.....	\$ 4,381	\$ 5,783	\$ 6,760
CMOs.....	893	2,215	2,403
Municipals.....	10,002	11,910	13,834
Total securities held-to-maturity.....	<u>\$ 15,276</u>	<u>\$ 19,908</u>	<u>\$ 22,997</u>

The following table summarizes the amounts and distribution of the Company's investment securities and the weighted average yields as of December 31, 2001:

(Dollars in thousands)	Within One Year		After One Year and Within Five Years		After Five Years and Within Ten Years		After Ten Years		Total	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
<b>Securities available-for-sale:</b>										
U.S. treasury.....	\$ 3,593	3.10%	\$ --	-- %	\$ --	-- %	\$ --	-- %	\$ 3,593	3.10%
U.S. Government Agencies.....	4,591	5.87%	49,171	4.73%	--	-- %	--	-- %	53,762	4.83%
Mortgage-backed securities.....	--	-- %	--	-- %	--	-- %	22,839	5.83%	22,839	5.83%
Municipals - tax exempt.....	2,194	6.24%	3,606	6.31%	3,473	6.95%	--	-- %	9,273	6.53%
Corporate bonds.....	--	-- %	2,067	4.48%	--	-- %	--	-- %	2,067	4.48%
Total available-for-sale.....	<u>10,378</u>	<u>4.99%</u>	<u>54,844</u>	<u>4.82%</u>	<u>3,473</u>	<u>6.95%</u>	<u>22,839</u>	<u>5.83%</u>	<u>91,534</u>	<u>5.17%</u>
<b>Securities held-to-maturity:</b>										
Mortgage-backed securities.....	--	-- %	4,381	6.35%	--	-- %	--	-- %	4,381	6.35%
CMOs.....	893	6.14%	--	-- %	--	-- %	--	-- %	893	6.14%
Municipals - taxable.....	1,003	6.47%	1,594	6.60%	--	-- %	--	-- %	2,597	6.55%
Municipals - tax exempt.....	--	-- %	3,285	6.72%	4,120	6.67%	--	-- %	7,405	6.74%
Total held-to-maturity.....	<u>1,896</u>	<u>6.13%</u>	<u>9,260</u>	<u>6.52%</u>	<u>4,120</u>	<u>6.67%</u>	<u>--</u>	<u>-- %</u>	<u>15,276</u>	<u>6.56%</u>
Total securities.....	<u>\$ 12,274</u>	<u>5.19%</u>	<u>\$ 64,104</u>	<u>5.07%</u>	<u>\$ 7,593</u>	<u>6.85%</u>	<u>\$ 22,839</u>	<u>5.83%</u>	<u>\$ 106,810</u>	<u>5.37%</u>

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

As of December 31, 2001, 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 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 \$20,250,000 and \$22,884,000 as of December 31, 2001 and 2000 were pledged to secure public and certain other deposits as required by law or contract.

## LOANS

Total portfolio loans grew to \$632,917,000 at December 31, 2001, up 4% from \$610,781,000 at December 31, 2000, adding to the increase of 52% from \$401,240,000 at December 31, 1999. The Company's allowance for loan losses was \$11,154,000, or 1.76% of total loans, as of December 31, 2001, as compared to \$9,651,000, or 1.58% of total loans, at December 31, 2000, and \$6,511,000, or 1.62% of total loans, at December 31, 1999. As of December 31, 2001 and 2000 the Company had no non-performing assets. As of December 31, 1999, non-performing assets were \$1,402,000.

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:

(Dollars in thousands)	December 31,									
	2001	% of Total	2000	% of Total	1999	% of Total	1998	% of Total	1997	% of Total
Commercial.....	\$ 208,713	33%	\$ 200,846	33%	\$ 141,101	35%	\$ 95,587	28%	\$ 69,060	35%
Real estate - mortgage.....	246,119	39%	230,468	38%	153,518	38%	100,870	30%	66,363	34%
Real estate - land and construction.....	174,077	27%	171,325	28%	96,868	24%	86,102	25%	57,019	29%
Consumer.....	3,833	1%	8,172	1%	10,048	3%	55,656	17%	5,307	2%
Total loans.....	632,742	100%	610,811	100%	401,535	100%	338,215	100%	197,749	100%
Deferred loan costs (fees).....	175		(30)		(295)		(284)		(403)	
Allowance for loan losses.....	(11,154)		(9,651)		(6,511)		(5,069)		(3,270)	
Loans, net.....	\$ 621,763		\$ 601,130		\$ 394,729		\$ 332,862		\$ 194,076	

The change in the Company's loan portfolio is primarily due to the increase in the commercial and real estate loan portfolio offset by a decline in consumer loans resulting from the reduction in installment loans mainly due to increased competition in the business and the normal maturation of these loans, and the sale of the Internet credit card portfolio in 1999. The increase in the commercial and real estate 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, 2001, 2000 and 1999, \$50.7 million, \$12.3 million and \$14.5 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 \$7.9 million and \$13.1 million at December 31, 2001. For HBEB these lending limits were \$1.9 million and \$3.1 million at December 31, 2001. For HBSV these lending limits were \$1.2 million and \$1.9 million at December 31, 2001. For BLA these lending limits were \$3.8 million and \$6.4 million at December 31, 2001.

The Company does not have any concentrations in its loan portfolio by industry or group of industries, however, 66% of its net loans were secured by real property as of December 31, 2001 and 2000. 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, 2001, approximately 90% of the Company's loan portfolio consisted of floating interest rate loans.

(Dollars in thousands)	<b>Due in One Year or Less</b>	<b>Year But Less Than Five Years</b>	<b>Over Five Years</b>	<b>Total</b>
Commercial.....	\$ 196,442	\$ 10,337	\$ 1,934	\$ 208,713
Real estate - mortgage.....	147,209	87,426	11,484	246,119
Real estate - land and construction.....	174,077	--	--	174,077
Consumer.....	3,289	544	--	3,833
Total loans.....	<u>\$ 521,017</u>	<u>\$ 98,307</u>	<u>\$ 13,418</u>	<u>\$ 632,742</u>
Loans with variable interest rates.....	\$ 506,065	\$ 60,133	\$ 2,351	\$ 568,549
Loans with fixed interest rates.....	14,952	38,174	11,067	64,193
Total loans.....	<u>\$ 521,017</u>	<u>\$ 98,307</u>	<u>\$ 13,418</u>	<u>\$ 632,742</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.

The Banks' 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. The Banks use 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. The Banks' control 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>2001</u>	<u>2000</u>
Commitments to extend credit.....	\$ 275,796	\$ 351,401
Standby letters of credit.....	2,526	6,792
	<u>\$ 278,322</u>	<u>\$ 358,193</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. The Banks evaluate each client's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Banks 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 the Banks 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 the Banks 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 non-performing assets at the dates indicated:

(Dollars in thousands)	December 31,				
	2001	2000	1999	1998	1997
Nonaccrual loans.....	\$ --	\$ --	\$ 1,402	\$ 1,354	\$ 61
Loans 90 days past due and still accruing.....	--	--	--	--	--
Restructured loans.....	--	--	--	--	--
Total nonperforming loans.....	--	--	1,402	1,354	61
Foreclosed assets.....	--	--	--	--	--
Total nonperforming assets.....	\$ --	\$ --	\$ 1,402	\$ 1,354	\$ 61
Nonperforming assets as a percentage of period end loans plus foreclosed assets.....	--	--	0.35%	0.40%	0.03%

As of December 31, 2001 and 2000, the Company had no loans on nonaccrual status, no loans past due 90 days or more and still accruing interest, and no impaired loans. As of December 31, 1999, the Company had \$1,402,000 in loans on nonaccrual status, no significant loans past due 90 days or more and still accruing interest, and no impaired loans. For the year ended December 31, 2001 and 2000, the Company did not have any foregone interest income on nonaccrual loans. For the year ended December 31, 1999, the Company had foregone \$63,000 of interest income on nonaccrual loans. The Company did not recognize any interest income for cash payments received on nonaccrual loans in 2001, 2000, or 1999.

The Company assigns a risk grade consistent with the system recommended by regulatory agencies to all of its loans. 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).

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. As of December 31, 1999, classified loans were \$5,728,000. These loans constituted 1% of total loans and 9% of capital and reserves as of that date. Other than those loans already classified at December 31, 2001, the Company has not identified any other 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, continued problems in the distribution of energy may effect the local market. Finally, 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 29.

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:

(Dollars in thousands)	2001	2000	1999	1998	1997
Balance, beginning of period.....	\$ 9,651	\$ 6,511	\$ 5,069	\$ 3,270	\$ 2,180
Charge-offs:					
Commercial.....	(708)	(52)	(203)	(108)	(223)
Real estate - mortgage.....	--	--	--	--	--
Real estate - land and construction.....	--	--	--	--	--
Consumer.....	(1)	--	(629)	(71)	(115)
Total charge-offs.....	(709)	(52)	(832)	(179)	(338)
Recoveries:					
Commercial.....	301	33	67	137	98
Real estate - mortgage.....	--	--	--	--	--
Real estate - land and construction.....	--	--	--	--	--
Consumer.....	1	--	9	35	--
Total recoveries.....	302	33	76	172	98
Net charge-offs.....	(407)	(19)	(756)	(7)	(240)
Provision for loan losses.....	1,910	3,159	2,198	1,806	1,330
Balance, end of period.....	<u>\$ 11,154</u>	<u>\$ 9,651</u>	<u>\$ 6,511</u>	<u>\$ 5,069</u>	<u>\$ 3,270</u>

## RATIOS:

Net charge-offs to average loans outstanding.....	0.07 %	-- %	0.20 %	-- %	0.14 %
Allowance for loan losses to average loans.....	1.84 %	1.80 %	1.71 %	1.87 %	1.97 %
Allowance for loan losses to total loans at end of period.....	1.76 %	1.58 %	1.62 %	1.50 %	1.66 %
Allowance for loan losses to nonperforming loans.....	-- %	-- %	464 %	374 %	5,360 %

Charge-offs reflect the realization of losses in the portfolio that were recognized previously though provisions for loan losses. The net charge-offs in 2001 were \$407,000, compared to \$19,000 in 2000, \$756,000 in 1999, \$7,000 in 1998, and \$240,000 in 1997. The increase in net charge-offs in 2001 was primarily due to the increase in

commercial loans 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,									
	2001		2000		1999		1998		1997	
	Percent of ALL in each category to total	Allowance loans	Percent of ALL in each category to total	Allowance loans	Percent of ALL in each category to total	Allowance loans	Percent of ALL in each category to total	Allowance loans	Percent of ALL in each category to total	Allowance loans
(Dollars in thousands)										
Commercial.....	\$ 5,489	2.63 %	\$ 4,244	2.11 %	\$ 3,069	2.18 %	\$ 1,961	2.05 %	\$ 1,171	1.70 %
Real estate - mortgage.....	1,420	0.58 %	1,509	0.65 %	1,025	0.67 %	617	0.61 %	444	0.67 %
Real estate - land and construction.....	3,066	1.76 %	2,084	1.22 %	1,343	1.39 %	1,173	1.36 %	676	1.19 %
Consumer.....	102	2.66 %	158	1.93 %	170	1.69 %	1,245	2.24 %	106	2.00 %
Unallocated.....	1,077	-- %	1,656	-- %	904	-- %	73	-- %	873	-- %
Total.....	\$ <u>11,154</u>	1.76 %	\$ <u>9,651</u>	1.58 %	\$ <u>6,511</u>	1.62 %	\$ <u>5,069</u>	1.50 %	\$ <u>3,270</u>	1.66 %

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 collectability 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. There were no specific allowances allocate at December 31, 2001 and 2000 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, 2001 was \$10,077,000, compared to \$7,995,000 on December 31, 2000. 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, 2001, the Company's unallocated allowance was \$1,077,000, compared to \$1,656,000 on December 31, 2000. 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 \$107,000 - \$193,000

- 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 \$179,000 - \$321,000
- 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 \$143,000 - \$257,000
- 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 \$215,000 - \$386,000
- 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 \$36,000 - \$65,000
- Credit Concentrations – The existence and effect of any concentrations of credit and changes in the level of such concentrations. Range of potential impact \$71,000 - \$128,000

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 \$807,908,000 at December 31, 2001, an increase of 9%, compared to \$738,186,000 at December 31, 2000. The largest increase was in time deposits \$100,000 and over, which increased to \$218,140,000 at December 31, 2001, as compared to \$171,863,000 at December 31, 2000, primarily due to the increase in brokered deposits to \$67,995,000 at December 31, 2001 up from \$9,238,000 at December 31, 2000. Noninterest bearing deposits were \$206,637,000 at December 31, 2001, consistent with the \$207,885,000 at December 31, 2000. Interest bearing demand deposits increased to \$80,529,000 at December 31, 2001, as compared to \$68,587,000 at December 31, 2000. Savings and money market deposits increased to \$229,994,000 at December 31, 2001, as compared to \$219,299,000 at December 31, 2000. Time deposits under \$100,000 increased to \$72,608,000 at December 31, 2001, as compared to \$70,552,000 at December 31, 2000.

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

	Years ended December 31,					
	2001		2000		1999	
	Average		Average		Average	
	Average Balance	Rate Paid	Average Balance	Rate Paid	Average Balance	Rate Paid
(Dollars in thousands)						
Demand, noninterest bearing.....	\$ 204,114	-- %	\$ 183,422	-- %	\$ 141,250	-- %
Demand, interest bearing.....	69,634	1.58 %	55,616	1.82 %	39,996	1.79 %
Savings and money market.....	227,344	3.09 %	228,336	4.16 %	186,112	3.28 %
Time deposits, under \$100.....	78,910	5.37 %	73,058	5.85 %	58,423	5.08 %
Time deposits, \$100 and over.....	166,268	5.18 %	151,275	5.75 %	86,963	4.83 %
Time deposits - Brokered Deposits.....	30,843	5.32 %	10,544	6.55 %	8,812	5.76 %
Total average deposits.....	<u>\$ 777,113</u>	2.91 %	<u>\$ 702,251</u>	3.44 %	<u>\$ 521,556</u>	2.78 %

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. As of December 31, 2000, the Company had a deposit mix of 30% in savings and money market accounts, 33% in time deposits, 9% in interest bearing demand accounts, and 28% in noninterest bearing demand deposits. On the same date, approximately \$6,931,000, or less than 1%, of deposits were from public sources, and approximately \$44,507,000, or 6%, of deposits were from title companies. The Company's net interest income is enhanced by increasing its percentage of noninterest bearing deposits.

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 \$67,995,000 at December 31, 2001, and \$9,238,000 at December 31, 2000. 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 and over as of December 31, 2000:

(Dollars in thousands)	% of	
	Balance	Total
Three months or less.....	\$ 92,438	42 %
Over three months through six months.....	69,889	32 %
Over six months through twelve months.....	16,630	8 %
Over twelve months.....	39,183	18 %
Total.....	<u>\$ 218,140</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, 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 \$798.1 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. As of December 31, 1999, the Company's primary liquidity ratio was 27.98%, comprised of \$25.5 million in investment securities available-for-sale of maturities (or probable calls) of up to five years, less \$17.3 million of securities that were pledged to secure public and certain other deposits as required by law and contract; Federal funds sold of \$135.9 million, and \$19.3 million in cash and due from banks, as a percentage of total unsecured deposits of \$584.1 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>2001</u>	<u>2000</u>	<u>1999</u>
Average balance during the year.....	\$ 2,436,000	\$ 2,020,000	\$ 16,887,000
Average interest rate during the year.....	5.80%	5.17%	5.30%
Maximum month-end balance during the year.....	\$ --	\$ 18,000,000	\$ 14,000,000
Average rate at December 31.....	--	5.13%	7.44%

The Company has Federal funds purchase lines and lines of credit of totaling \$46,000,000. As of December 31, 2001, the Company had no borrowing from FHLB.

## CAPITAL RESOURCES

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

(Dollars in thousands)	<u>December 31,</u>		
	<u>2001</u>	<u>2000</u>	<u>1999</u>
<b>Capital components:</b>			
Tier 1 Capital.....	\$ 91,598	\$ 78,982	\$ 57,610
Tier 2 Capital.....	9,664	9,427	6,154
Total risk-based capital.....	<u>\$ 101,262</u>	<u>\$ 88,409</u>	<u>\$ 63,764</u>
Risk-weighted assets.....	\$ 779,060	\$ 753,947	\$ 509,748
Quarterly average assets.....	\$ 898,020	\$ 850,072	\$ 674,088

	<u>MINIMUM REGULATORY REQUIREMENTS</u>			
<b>Capital ratios:</b>				
Total risk-based capital.....	13.0%	11.7%	12.5%	8.0%
Tier 1 risk-based capital.....	11.8%	10.5%	11.3%	4.0%
Leverage ratio(1).....	10.2%	9.3%	8.5%	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, 2001. The risk-based and leverage capital ratios are defined in Item 1 - "Business - Supervision and Regulation - Capital Adequacy Guidelines" on page 7.

At December 31, 2001, 2000 and 1999, the Company's capital met all minimum regulatory requirements. As of December 31, 2001 and 2000, management believes that HBC, HBEB, HBSV, and BLA were considered "well capitalized." At December 31, 1999, management believes that HBC, HBEB, and BLA were considered "well capitalized." HBSV commenced operations on January 18, 2000.

In August 1999, the Company completed a best efforts public stock offering selling 758,138 shares at \$15.00 per share. Total proceeds from this offering were \$11,200,000 after deducting expenses of \$172,000. The Company used \$7,000,000 of the proceeds of the offering to capitalize HBSV, which commenced operations on January 18, 2000.

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 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 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.

See "Mandatorily Redeemable Cumulative Trust Preferred Securities of Subsidiary Grantor Trust" on page 21. Under applicable regulatory guidelines the trust preferred securities currently qualify as Tier I capital.

#### ***RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS***

In June 2001, the Financial Accounting Standards Board approved for issuance Statement of Financial Accounting Standard (SFAS) No. 141, *Business Combinations* and SFAS No. 142, *Goodwill and Other Intangible Assets*. SFAS No. 141 requires that all business combinations initiated after June 30, 2001 be accounted for under the purchase method of accounting and address the initial recognition and measurement of goodwill and other intangible assets acquired in a business combination. SFAS No. 142 addresses the initial recognition and measurement of intangible assets acquired outside of a business combination and the accounting for goodwill and other intangible assets subsequent to their acquisition. SFAS No. 142 provides that intangible assets with finite useful lives will be amortized and that goodwill and intangible assets with indefinite lives will not be amortized, but will be required to be tested at least annually for impairment. The Company will adopt SFAS No. 142 for its fiscal year beginning January 1, 2002. The Company does not expect the adoption of SFAS No. 142 to have a material effect on its financial position, results of operations and cash flows, as the Company did not have any goodwill or intangible assets at December 31, 2001.

#### ***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, 2001, 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:

(Dollars in thousands)	<b>Due Within Three Months</b>	<b>Due in Three to Twelve Months</b>	<b>Due After One to Five Years</b>	<b>Due After Five Years</b>	<b>Not Rate- Sensitive</b>	<b>Total</b>
<b>INTEREST EARNING ASSETS:</b>						
Federal funds sold.....	\$ 71,600	\$ --	\$ --	\$ --	\$ --	\$ 71,600
Interest bearing deposits in banks.....	7,704	--	--	--	--	7,704
Securities.....	2,509	9,765	74,065	20,471	--	106,810
Total loans, including loans held-for-sale, net of deferred fees.....	512,970	40,682	98,307	13,419	--	665,378
Total interest earning assets.....	<u>594,783</u>	<u>50,447</u>	<u>172,372</u>	<u>33,890</u>	<u>--</u>	<u>851,492</u>
Cash and due from banks.....	--	--	--	--	27,015	27,015
Other assets.....	--	--	--	--	34,223	34,223
Total assets.....	<u>\$ 594,783</u>	<u>\$ 50,447</u>	<u>\$ 172,372</u>	<u>\$ 33,890</u>	<u>\$ 61,238</u>	<u>\$ 912,730</u>
<b>INTEREST BEARING LIABILITIES:</b>						
Demand, interest bearing.....	\$ 80,529	\$ --	\$ --	\$ --	\$ --	\$ 80,529
Savings and money market.....	229,994	--	--	--	--	229,994
Time deposits.....	124,813	122,063	43,772	100	--	290,748
Mandatorily redeemable cumulative trust preferred securities.....	--	--	--	19,000	--	19,000
Total interest bearing liabilities.....	<u>435,336</u>	<u>122,063</u>	<u>43,772</u>	<u>19,100</u>	<u>--</u>	<u>620,271</u>
Demand noninterest bearing.....	66,328	--	--	--	140,309	206,637
Accrual interest payable and other liabilities.....	--	--	--	--	11,248	11,248
Shareholders' equity.....	--	--	--	--	74,574	74,574
Total liabilities and shareholders' equity.....	<u>\$ 501,664</u>	<u>\$ 122,063</u>	<u>\$ 43,772</u>	<u>\$ 19,100</u>	<u>\$ 226,131</u>	<u>\$ 912,730</u>
Interest rate sensitivity GAP.....	<u>\$ 93,119</u>	<u>\$ (71,616)</u>	<u>\$ 128,600</u>	<u>\$ 14,790</u>	<u>\$ (164,893)</u>	<u>\$ --</u>
Cumulative interest rate						
sensitivity GAP.....	\$ 93,119	\$ 21,503	\$ 150,103	\$ 164,893	\$ --	\$ --
Cumulative interest rate						
sensitivity GAP ratio.....	10.20 %	2.36 %	16.45 %	18.07 %	-- %	-- %

The careful planning of asset and liability maturities and the matching of interest rates to correspond with this maturity matching is an integral part of the active 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 in relatively short maturities.

Interest rate changes do not affect all categories of assets and liabilities equally or at the same time. Varying interest rate environments can create unexpected changes in prepayment levels of assets and liabilities, which may have a significant effect on the net interest margin and are not reflected in the interest sensitivity analysis table. Because of these factors, an interest sensitivity gap report may not provide a complete assessment of the exposure to changes in interest rates. 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 the Banks, 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 the Banks' 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, 2001, 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, 2001, it was estimated that the Company's MV would increase 9.63% in the event of a 200 basis point increase in market interest rates. The Company's MV at the same date would decrease 11.27% in the event of a 200 basis point decrease in market interest rates.

Presented below, as of December 31, 2001 and 2000, 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:

(Dollars in thousands)	2001				2000			
	\$ Change	% Change	Market Value as a % of		\$ Change	% Change	Market Value as a % of	
	in Market	in Market	Present Value of Assets		in Market	in Market	Present Value of Assets	
	Value	Value	MV Ratio	Change (bp)	Value	Value	MV Ratio	Change (bp)
Change in rates								
+ 200 bp.....	\$ 12,254	9.63 %	15.3 %	134	\$ 8,617	8.04 %	13.7 %	102
0 bp.....	--	-- %	14.0 %	--	--	-- %	12.7 %	--
- 200 bp.....	\$ (14,344)	(11.27)%	12.4 %	(157)	\$ (9,532)	(8.89)%	11.5 %	(113)

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 institution's 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' reports are set forth on pages 54 through 82, which follow Item 14 - "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,	September 30,	June 30,	March 31,	December 31,	September 30,	June 30,	March 31,
	2001	2001	2001	2001	2000	2000	2000	2000
Interest income.....	\$ 14,414	\$ 15,943	\$ 16,851	\$ 18,162	\$ 19,089	\$ 18,553	\$ 16,301	\$ 13,978
Interest expense.....	5,250	5,803	6,231	7,082	7,108	7,213	5,921	4,859
Net interest income.....	9,164	10,140	10,620	11,080	11,981	11,340	10,380	9,119
Provision for loan losses.....	576	279	528	527	1,290	655	534	680
Net interest income after provision.....	8,588	9,861	10,092	10,553	10,691	10,685	9,846	8,439
Noninterest income.....	1,327	1,737	1,647	1,221	743	785	614	735
Noninterest expense.....	7,725	8,687	8,669	8,267	11,002	8,043	8,225	6,790
Net income before taxes.....	2,190	2,911	3,070	3,507	432	3,427	2,235	2,384
Provision for income taxes.....	816	1,088	1,180	1,326	183	1,253	746	867
Net income.....	\$ 1,374	\$ 1,823	\$ 1,890	\$ 2,181	\$ 249	\$ 2,174	\$ 1,489	\$ 1,517
Net income per share basic.....	\$ 0.12	\$ 0.17	\$ 0.17	\$ 0.20	\$ 0.02	\$ 0.20	\$ 0.14	\$ 0.15
Net income per share diluted.....	\$ 0.12	\$ 0.16	\$ 0.17	\$ 0.19	\$ 0.02	\$ 0.20	\$ 0.13	\$ 0.14

## 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 23, 2002 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 as of March 28, 2002 is 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 23, 2002 Annual Meeting of Shareholders.

## ITEM 12 - SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT - BENEFICIAL OWNERSHIP OF COMMON STOCK

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 23, 2002 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 23, 2002 Annual Meeting of Shareholders.

### PART IV

## ITEM 14 - 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 54 through 82.

### (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

		Incorporated by Reference to Form				
		Filed Herewith	8-A Dated	10-Q Dated	10-K Dated	Exhibit No.
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, dated 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
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	X		4.6
4.7	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	X		4.7
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		
23.2	Consent of Arthur Andersen LLP	X		

\* Management contract or compensatory plan or arrangement.

**(b) Reports on Form 8-K**

The Registrant filed Current Reports on Form 8-K dated: November 15, 2001 under Items 5 and 7, regarding its adoption of a shareholder rights plan; and dated January 25, 2002 under Item 5, to report its year end 2001 financial results, and containing condensed summarized statements of financial position and results of operations.

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## SIGNATURES

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

Heritage Commerce Corp

BY: /s/ Brad Smith

Brad Smith

Chairman of the Board and CEO

DATE: March 28, 2002

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, 2002
<u>/s/ JAMES BLAIR</u> James Blair	Director	March 28, 2002
<u>/s/ RICHARD CONNIFF</u> Richard Conniff	Director and President of the Company and Chief Operating Officer	March 28, 2002
<u>/s/ WILLIAM DEL BIAGGIO, JR.</u> William Del Biaggio, Jr.	Director	March 28, 2002
<u>/s/ ANNEKE DURY</u> Anneke Dury	Director	March 28, 2002
<u>/s/ HUGH BARTON</u> Hugh Barton	Director	March 28, 2002
<u>/s/ ROY LAVE</u> Roy Lave	Director	March 28, 2002
<u>/s/ HOWARD J. WEILAND</u> Howard J. Weiland	Director	March 28, 2002
<u>/s/ JOHN W. LARSEN</u> John W. Larsen	Director	March 28, 2002
<u>/s/ LAWRENCE D. MCGOVERN</u> Lawrence D. McGovern	Executive Vice President and Chief Financial Officer, Principal Financial and Accounting Officer	March 28, 2002
<u>/s/ LON NORMANDIN</u> Lon Normandin	Director	March 28, 2002
<u>/s/ JACK PECKHAM</u> Jack Peckham	Director	March 28, 2002

<u>/s/ ROBERT PETERS</u> Robert Peters	Director	March 28, 2002
<u>/s/ KURT HAMMERSTROM</u> Kurt Hammerstrom	Director	March 28, 2002
<u>/s/ HUMPHREY POLANEN</u> Humphrey Polanen	Director	March 28, 2002
<u>/s/ BRAD L. SMITH</u> Brad L. Smith	Director and Chairman of the Company and Chief Executive Officer, Principal Executive Officer	March 28, 2002

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**HERITAGE COMMERCE CORP**  
**INDEX TO FINANCIAL STATEMENTS**  
**DECEMBER 31, 2001**

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**Item 14 (a)(1)**

**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, 2001 and 2000, 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, 2001. 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. The consolidated financial statements give retroactive effect to the merger of Heritage Commerce Corp and Western Holdings Bancorp ("Western Holdings") on October 1, 2000, which has been accounted for as a pooling of interests as described in Note 2 to the consolidated financial statements. We did not audit the statements of income, changes in shareholders' equity, and cash flows of Western Holdings for the years ended December 31, 1999, which statements reflect: total net interest income of \$9,277,000 and net income of \$1,643,000. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for Western Holdings for 1999, is based solely on the report of such other auditors.

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 and the report of the other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and the report of the other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Heritage Commerce Corp and subsidiaries as of December 31, 2001 and 2000, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2001 in conformity with accounting principles generally accepted in the United States of America.

/s/ Deloitte & Touche LLP

San Jose, California  
January 24, 2002

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**Item 14 (a)(2)**

**INDEPENDENT AUDITORS' REPORT**

To the Board of Directors and Shareholders of  
Western Holdings Bancorp:

We have audited the consolidated statements of income, shareholders' equity, and cash flows of Western Holdings Bancorp (a California corporation) and Subsidiary (the Company) for the year ended December 31, 1999, prior to the restatement (and, therefore, are not presented herein) for the merger with Heritage Commerce Corp on October 1, 2000, which was accounted for as a pooling of interests (see Note 2 to the restated financial statements). These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States. 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 audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the results of operations and cash flows of Western Holdings Bancorp and Subsidiary for the year ended December 31, 1999, in conformity with accounting principles generally accepted in the United States.

/s/ Arthur Andersen LLP

San Francisco, California,  
January 21, 2000

**HERITAGE COMMERCE CORP  
CONSOLIDATED BALANCE SHEETS**

(Dollars in thousands)	<b>December 31,</b>	
	<b>2001</b>	<b>2000</b>
<b>ASSETS</b>		
Cash and due from banks.....	\$ 34,719	\$ 40,769
Federal funds sold.....	71,600	19,300
Total cash and cash equivalents.....	106,319	60,069
Securities available-for-sale, at fair value.....	91,534	90,894
Securities held-to-maturity, at amortized cost..... (fair value of \$15,708, for 2001 and \$20,075 for 2000)	15,276	19,908
Loans held for sale, at lower of cost or market.....	32,461	35,931
Loans, net of deferred costs of \$175 for 2001 and deferred fees of \$30 for 2000.....	632,917	610,781
Allowance for probable loan losses.....	(11,154)	(9,651)
Loans, net.....	621,763	601,130
Premises and equipment, net.....	5,470	6,089
Accrued interest receivable and other assets.....	15,128	13,246
Other investments.....	24,779	18,957
<b>TOTAL.....</b>	<b>\$ 912,730</b>	<b>\$ 846,224</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Liabilities:		
Deposits		
Demand, noninterest bearing.....	\$ 206,637	\$ 207,885
Demand, interest bearing.....	80,529	68,587
Savings and money market.....	229,994	219,299
Time deposits, under \$100.....	72,608	70,552
Time deposits, \$100 and over.....	218,140	171,863
Total deposits.....	807,908	738,186
Federal Home Loan Bank borrowings.....	--	18,000
Accrued interest payable and other liabilities.....	11,248	10,305
Mandatorily redeemable cumulative trust preferred securities of subsidiary grantor trust.....	19,000	14,000
Total liabilities.....	838,156	780,491
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: 11,114,967 in 2001 and 10,939,124 in 2000.....	63,536	62,469
Accumulated other comprehensive income, net of taxes.....	1,021	515
Retained earnings.....	10,017	2,749
Total shareholders' equity.....	74,574	65,733
<b>TOTAL.....</b>	<b>\$ 912,730</b>	<b>\$ 846,224</b>

See notes to consolidated financial statements.

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

(Amounts in thousands, except per share data)	Years ended December 31,		
	2001	2000	1999
<b>Interest income:</b>			
Loans, including fees.....	\$ 57,518	\$ 56,709	\$ 36,742
Securities, taxable.....	4,399	5,571	4,699
Securities, non-taxable.....	870	617	606
Interest bearing deposits in banks.....	157	66	--
Federal funds sold.....	2,426	4,958	3,371
<b>Total interest income.....</b>	<b>65,370</b>	<b>67,921</b>	<b>45,418</b>
<b>Interest expense:</b>			
Deposits.....	22,597	24,174	14,502
Mandatorily redeemable trust preferred securities.....	1,644	823	--
Other.....	125	104	896
<b>Total interest expense.....</b>	<b>24,366</b>	<b>25,101</b>	<b>15,398</b>
<b>Net interest income before provision for probable loan losses.....</b>	<b>41,004</b>	<b>42,820</b>	<b>30,020</b>
Provision for probable loan losses.....	1,910	3,159	2,198
<b>Net interest income after provision for probable loan losses.....</b>	<b>39,094</b>	<b>39,661</b>	<b>27,822</b>
<b>Noninterest income:</b>			
Gain on sale of loans.....	1,758	--	262
Other investments.....	1,029	778	429
Service charges and other fees on deposit accounts.....	967	716	560
Gain on sales of securities available-for-sale.....	732	44	969
Servicing income.....	356	236	1,903
Gain on sale of Internet credit card portfolio.....	--	60	289
Gain on sale of shares of demutualized life insurance company.....	--	47	530
Gain on sale of deposits.....	--	16	240
Other.....	1,090	980	869
<b>Total noninterest income.....</b>	<b>5,932</b>	<b>2,877</b>	<b>6,051</b>
<b>Noninterest expenses:</b>			
Salaries and employee benefits.....	18,120	16,127	13,834
Occupancy.....	2,847	2,399	2,034
Client services.....	1,889	1,839	1,527
Furniture and equipment.....	1,453	1,329	1,350
Professional fees.....	1,447	1,861	1,659
Loan origination costs.....	1,335	1,011	539
Advertising and promotion.....	1,116	1,029	1,113
Stationery & supplies.....	489	388	300
Telephone.....	358	359	208
Merger-related costs.....	--	3,164	--
Other.....	4,294	4,554	4,034
<b>Total noninterest expenses.....</b>	<b>33,348</b>	<b>34,060</b>	<b>26,598</b>
<b>Income before provision for income taxes.....</b>	<b>11,678</b>	<b>8,478</b>	<b>7,275</b>
Provision for income taxes.....	4,410	3,049	2,606
<b>Net income.....</b>	<b>\$ 7,268</b>	<b>\$ 5,429</b>	<b>\$ 4,669</b>
<b>Earnings per share:</b>			
Basic.....	\$ 0.66	\$ 0.51	\$ 0.47
Diluted.....	\$ 0.64	\$ 0.49	\$ 0.43

See notes to consolidated financial statements.

**HERITAGE COMMERCE CORP**  
**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**  
**YEARS ENDED DECEMBER 31, 2001, 2000, AND 1999**

(Dollars in thousands)	Common Stock		Accumulated Other Comprehensive Income	Retained Earnings	Total Shareholders' Equity	Other Comprehensive Income
	Shares	Amount	(Net of Taxes)			
<b>BALANCES, JANUARY 1, 1999</b> .....	8,576,147	\$ 36,815	\$ 542	\$ 4,633	\$ 41,990	
Net income.....	--	--	--	4,669	4,669	\$ 4,669
Net change in unrealized loss on securities available-for-sale, net of reclassification adjustment and taxes.....	--	--	(1,796)	--	(1,796)	(1,796)
Total comprehensive income.....	--	--	--	--	--	\$ 2,873
Common stock issued pursuant to June 1999 offering (net of issuance costs of \$172,000).....	758,138	11,200	--	--	11,200	
Stock dividend.....	302,171	2,710	--	(2,710)	--	
Cash paid for fractional shares.....	(199)	(4)	--	--	(4)	
Stock options exercised.....	101,482	485	--	--	485	
<b>BALANCES, DECEMBER 31, 1999</b> .....	9,737,739	51,206	(1,254)	6,592	56,544	
Net income.....	--	--	--	5,429	5,429	\$ 5,429
Net change in unrealized gain on securities available-for-sale, net of reclassification adjustment and taxes.....	--	--	1,769	--	1,769	1,769
Total comprehensive income.....						\$ 7,198
Stock dividend.....	639,444	9,272	--	(9,272)	--	
Cash paid for fractional shares.....	(325)	(3)	--	--	(3)	
Stock options exercised.....	562,266	1,994	--	--	1,994	
<b>BALANCES, DECEMBER 31, 2000</b> .....	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	506
Total comprehensive income.....						\$ 7,774
Stock options exercised.....	175,843	1,067	--	--	1,067	
<b>BALANCES, DECEMBER 31, 2001</b> .....	11,114,967	\$ 63,536	\$ 1,021	\$ 10,017	\$ 74,574	

See notes to consolidated financial statements.

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

(Dollars in thousands)	Years ended December 31,		
	2001	2000	1999
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net income.....	\$ 7,268	\$ 5,429	\$ 4,669
Adjustments to reconcile net income to net cash provided by operating activities:			
Loss on disposals of property and equipment.....	--	--	(283)
Depreciation and amortization.....	1,527	777	706
Provision for probable loan losses.....	1,910	3,159	2,198
Gain on sales of securities available-for-sale.....	(732)	(44)	(969)
Provision for deferred income taxes.....	2,451	391	(709)
Amortization / accretion of discounts and premiums on securities.....	(668)	92	(239)
Proceeds from sales of loans held for sale.....	42,613	--	4,317
Originations of loans held for sale.....	(52,411)	(13,845)	(17,941)
Maturities of loans held for sale.....	13,268	157	7,839
Effect of changes in:			
Accrued interest receivable and other assets.....	(4,260)	(3,772)	(1,488)
Accrued interest payable and other liabilities.....	671	2,606	10,133
Net cash provided by (used in) operating activities.....	11,637	(5,050)	8,233
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Net increase in loans.....	(22,543)	(209,563)	(47,203)
Purchases of securities available-for-sale.....	(82,098)	(52,042)	(39,550)
Maturities/Paydowns/Calls of securities available-for-sale.....	24,484	5,230	30,652
Proceeds from sales of securities available-for-sale.....	59,080	9,937	53,475
Maturities/Paydowns/Calls of securities held-to-maturity.....	4,631	3,040	3,949
Purchase of corporate-owned life insurance.....	(5,989)	(3,763)	(4,214)
Purchase of property and equipment.....	(908)	(1,180)	(862)
Redemption (purchase) of other investment.....	167	(521)	1,858
Net cash used in investing activities.....	(23,176)	(248,862)	(1,895)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Net increase in deposits.....	69,722	136,766	91,504
Proceeds from issuance of mandatorily redeemable cumulative trust preferred securities of Subsidiary Grantor Trust.....	5,000	14,000	--
Net proceeds from issuance of common stock.....	1,067	1,991	11,681
Net change in FHLB borrowings.....	(18,000)	6,000	(17,000)
Net cash provided by financing activities.....	57,789	158,757	86,185
Net increase (decrease) in cash and cash equivalents.....	46,250	(95,155)	92,523
Cash and cash equivalents, beginning of year.....	60,069	155,224	62,701
Cash and cash equivalents, end of year.....	\$ 106,319	\$ 60,069	\$ 155,224
<b>Supplemental disclosures of cash flow information:</b>			
Cash paid during the year for:			
Interest.....	\$ 24,287	\$ 17,324	\$ 14,383
Income taxes.....	\$ 6,600	\$ 5,974	\$ 3,443
<b>Supplemental schedule of non-cash investing and financing activity:</b>			
Transfer from retained earnings to common stock for stock dividend.....	\$ --	\$ 9,272	\$ 2,710
Transfer of investment securities from HTM to AFS.....	\$ --	\$ --	\$ 11,669

See notes to consolidated financial statements.

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**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 Altos ("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, Bank of Los Altos, 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, and, during 2001, formed Heritage Statutory Trust II, which are Delaware statutory business trusts formed for the exclusive purpose of issuing and selling trust preferred securities. The accounting and reporting policies of the Company and its subsidiaries 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 subsidiaries. All material 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 comprehensive income, which is a separate component of shareholders' equity, until realized. Securities held-to-maturity are recorded at amortized cost, based on the Company's positive intent and ability to hold the securities to maturity.

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, determined in the aggregate.

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. The majority of the Company's loans are at variable interest rates. Interest on loans is credited to income when earned.

Generally, if a loan is classified as nonaccrual, the accrual of interest is discontinued, any accrued and unpaid interest is reversed, and the amortization of deferred loan fees and costs is discontinued. Loans are classified as nonaccrual 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.

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, 2001 and 2000 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.

#### ***Other Investments***

Other investments consist of Federal Reserve Board and Federal Home Loan Bank 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.

#### ***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*. The Company presents the required proforma disclosures of the effect of stock-based compensation on net income and earnings per share using the fair value method in accordance with SFAS No. 123, *Accounting for Stock-Based Compensation*.

### ***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 only source of other comprehensive income is derived from unrealized gain and loss on securities available-for-sale and is presented net of tax. The following is a summary of the components of other comprehensive income.

(Amounts in thousands)	Years ended December 31,		
	2001	2000	1999
Net income.....	\$ 7,268	\$ 5,429	\$ 4,669
Other comprehensive income, net of tax:			
Net unrealized holding gain (loss) on available-for-sale securities during the year.....	961	1,797	(1,174)
Less: reclassification adjustment for realized gains on available for sale securities included in net income during the year.....	455	28	622
Other comprehensive income (loss).....	506	1,769	(1,796)
Comprehensive income.....	<u>\$ 7,774</u>	<u>\$ 7,198</u>	<u>\$ 2,873</u>

### ***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.

### ***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,		
	2001	2000	1999
Weighted average common shares outstanding - used in computing basic earnings per share.....	11,082,157	10,607,584	9,885,036
Dilutive effect of stock options outstanding, using the treasury stock method.....	297,564	500,745	1,037,941
Shares used in computing diluted earnings per share.....	<u>11,379,721</u>	<u>11,108,329</u>	<u>10,922,977</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 warrants and included this amount in other assets. The Company does not have any freestanding derivatives and is not involved in any hedging activities.

### ***Reclassifications***

Certain amounts in the 2000 and 1999 financial statements have been reclassified to conform to the 2001 presentation. These reclassifications had no impact on shareholders' equity or net income.

### ***Recently issued Accounting Pronouncements***

In June 2001, the Financial Accounting Standards Board approved for issuance Statement of Financial Accounting Standard (SFAS) No. 141, *Business Combinations* and SFAS No. 142, *Goodwill and Other Intangible Assets*. SFAS No. 141 requires that all business combinations initiated after June 30, 2001 be accounted for under the purchase method of accounting and address the initial recognition and measurement of goodwill and other intangible assets acquired in a business combination. SFAS No. 142 addresses the initial recognition and measurement of intangible assets acquired outside of a business combination and the accounting for goodwill and other intangible assets subsequent to their acquisition. SFAS No. 142 provides that intangible assets with finite useful lives will be amortized and that goodwill and intangible assets with indefinite lives will not be amortized, but will be required to be tested at least annually for impairment. The Company will adopt SFAS No. 142 for its fiscal year beginning January 1, 2002. The Company does not expect the adoption of SFAS No. 142 to have a material effect on its financial position, results of operations and cash flows, as the Company did not have any goodwill or intangible assets at December 31, 2001.

## **(2) BUSINESS COMBINATIONS**

In October 2000, the Company merged with Western Holdings Bancorp and its wholly owned subsidiary, Bank of Los Altos, 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, 2001 were as follows:

(Dollars in thousands)	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Estimated Fair Value</u>
<b>Securities available-for-sale:</b>				
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.....	2,046	21	--	2,067
<b>Total securities available-for-sale.....</b>	<b><u>\$ 89,973</u></b>	<b><u>\$ 1,589</u></b>	<b><u>\$ 28</u></b>	<b><u>\$ 91,534</u></b>
<b>Securities held-to-maturity:</b>				
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.....	893	17	--	910
<b>Total securities held-to-maturity.....</b>	<b><u>\$ 15,276</u></b>	<b><u>\$ 432</u></b>	<b><u>\$ --</u></b>	<b><u>\$ 15,708</u></b>

The amortized cost and estimated fair value of securities as of December 31, 2000 were as follows:

(Dollars in thousands)	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Estimated Fair Value</u>
<b>Securities available-for-sale:</b>				
U.S. Treasury.....	\$ 8,527	\$ --	\$ 3	\$ 8,524
U.S. Government Agencies.....	47,694	508	--	48,202
Municipals.....	14,055	242	--	14,297
FHLMC mortgage-backed securities.....	10,551	179	--	10,730
GNMA mortgage-backed securities.....	8,212	--	72	8,140
Other debt Securities.....	1,000	1	--	1,001
<b>Total securities available-for-sale.....</b>	<b><u>\$ 90,039</u></b>	<b><u>\$ 930</u></b>	<b><u>\$ 75</u></b>	<b><u>\$ 90,894</u></b>
<b>Securities held-to-maturity:</b>				
Municipals.....	\$ 11,910	\$ 211	\$ --	\$ 12,121
FHLMC mortgage-backed securities.....	3,573	--	12	3,561
GNMA mortgage-backed securities.....	2,210	--	7	2,203
CMOs.....	2,215	--	25	2,190
<b>Total securities held-to-maturity.....</b>	<b><u>\$ 19,908</u></b>	<b><u>\$ 211</u></b>	<b><u>\$ 44</u></b>	<b><u>\$ 20,075</u></b>

The amortized cost and estimated fair values of securities as of December 31, 2001 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>Held-to-maturity</u>		<u>Available-for-sale</u>	
	<u>Amortized</u>	<u>Estimated</u>	<u>Amortized</u>	<u>Estimated</u>
		<u>Cost</u>		<u>Fair</u>
(Dollars in thousands)		<u>Value</u>		<u>Value</u>
Due within one year.....	\$ 1,896	\$ 1,928	\$ 10,258	\$ 10,378
Due after one through five years.....	9,260	9,523	63,592	64,805
Due after five through ten years.....	4,120	4,257	14,304	14,536
Due after ten years.....	--	--	1,819	1,815
Total.....	<u>\$ 15,276</u>	<u>\$ 15,708</u>	<u>\$ 89,973</u>	<u>\$ 91,534</u>

Sales of securities available-for-sale resulted in gross realized gains of \$732,000, \$44,000, and \$969,000 during the years ended December 31, 2001, 2000, and 1999, respectively.

Sales of securities available-for-sale did not result in any gross realized losses for the years ended December 31, 2001, 2000 and 1999.

Securities with amortized cost of \$20,084,000 and \$22,884,000 as of December 31, 2001 and 2000 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:

(Dollars in thousands)	<u>2001</u>	<u>2000</u>
Loans held for sale.....	\$ <u>32,461</u>	\$ <u>35,931</u>
Loans held for investment		
Commercial.....	\$ 208,713	\$ 200,846
Real estate - mortgage.....	246,119	230,468
Real estate - land and construction.....	174,077	171,325
Consumer.....	3,833	8,172
Total loans.....	<u>632,742</u>	<u>610,811</u>
Deferred loan costs (fees).....	175	(30)
Allowance for probable loan losses.....	(11,154)	(9,651)
Loans, net.....	<u>\$ 621,763</u>	<u>\$ 601,130</u>

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

(Dollars in thousands)	<b>Years ended December 31,</b>		
	<b>2001</b>	<b>2000</b>	<b>1999</b>
Balance, beginning of year.....	\$ 9,651	\$ 6,511	\$ 5,069
Loans charged-off.....	(709)	(52)	(832)
Recoveries.....	302	33	76
Net loans charged-off.....	(407)	(19)	(756)
Provision for probable loan losses.....	1,910	3,159	2,198
Balance, end of year.....	<u>\$ 11,154</u>	<u>\$ 9,651</u>	<u>\$ 6,511</u>

As of December 31, 2001 and 2000, the Company had no loans on nonaccrual status, no loans past due 90 days or more and still accruing interest, and no impaired loans. As of December 31, 1999, the Company had \$1,402,000 in loans on nonaccrual status, no significant loans past due 90 days or more and still accruing interest, and no impaired loans. For the year ended December 31, 2001 and 2000, the Company did not have any foregone interest income on non-accrual loans. For the years ended December 31, 1999, the Company had foregone \$63,000 of interest income on non-accrual loans. The Company did not recognize any interest income for cash payments received on nonaccrual loans in 2001, 2000, or 1999.

Concentrations of credit risk arise when a number of clients are engaged in similar business activities, or activities in the same geographic region, or have similar features that would cause their ability to meet contractual obligations to be similarly affected by changes in economic conditions. The Company's loan portfolio is concentrated in commercial (primarily manufacturing, wholesale, and service) and real estate lending, with the balance in consumer loans. While no specific industry concentration is considered significant, the Company's lending operations are located in the Company's market areas that are dependent on the technology and real estate industries and their supporting companies. Thus, the Company's borrowers could be adversely impacted by a 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, 2001 and 2000.

(Dollars in thousands)	<b>2001</b>	<b>2000</b>
Beginning balance.....	\$ 2,075	\$ 1,456
Advances on loans during the year.....	3,214	1,517
Repayment on loans during the year.....	(1,212)	(898)
Ending balance.....	<u>\$ 4,077</u>	<u>\$ 2,075</u>

### **Loan Servicing**

At December 31, 2001 and 2000, the Company serviced loans guaranteed by the Small Business Administration which it had sold to the secondary market of approximately \$50,718,000 and \$12,264,000, respectively.

At December 31, 2001, the balance of the servicing assets was \$783,000, and its market value was \$956,000. There was no valuation allowance as of December 31, 2001. The Interest-Only (I/O) strip receivable was recorded at \$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 which was included in interest income was \$366,000 in 2001 and was not significant in 2000 and 1999. Amortization of the related assets for 2001 was \$643,000. 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, 2001, 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.

## (5) PREMISES AND EQUIPMENT

Premises and equipment as of December 31 were as follows:

(Dollars in thousands)	<u>2001</u>	<u>2000</u>
Furniture and equipment.....	\$ 6,882	\$ 6,064
Leasehold improvements.....	3,949	3,859
	<u>10,831</u>	<u>9,923</u>
Accumulated depreciation and amortization.....	(5,361)	(3,834)
Premises and equipment, net.....	<u>\$ 5,470</u>	<u>\$ 6,089</u>

Depreciation expense was \$1,527,000, \$777,000 and \$706,000 for the years ended December 31, 2001, 2000, and 1999, respectively.

## (6) DEPOSITS

At December 31, 2001, the scheduled maturities of time deposits were as follows:

(Dollars in thousands)	
Year	
2002.....	\$ 246,575
2003.....	34,691
2004.....	8,961
2005.....	521
Total time deposits.....	<u>\$ 290,748</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, 2001, the Company had no borrowing from the FHLB. At December 31, 2001, the Company has Federal funds purchase lines and lines of credit of totaling \$46,000,000.

(Dollars in thousands)	<u>December 31,</u>		
	<u>2001</u>	<u>2000</u>	<u>1999</u>
Long-term borrowings:			
FHLB loan, fixed rate of 5.84%.....	\$ --	\$ --	\$ 2,000
FHLB loan, fixed rate of 6.29%.....	--	--	3,000
Total long-term borrowings.....	<u>--</u>	<u>--</u>	<u>5,000</u>
Short-term borrowings.....	--	18,000	7,000
Total FHLB borrowings.....	<u>\$ --</u>	<u>\$ 18,000</u>	<u>\$ 12,000</u>

Information concerning borrowings under the above arrangements is as follows:

(Dollars in thousands)	<b>December 31,</b>		
	<b>2001</b>	<b>2000</b>	<b>1999</b>
Average balance during the year.....	\$ 2,436	\$ 2,020	\$ 16,887
Average interest rate during the year.....	5.80%	5.17%	5.30%
Maximum month-end balance during the year .....	\$ --	\$ 18,000	\$ 14,000
Average rate at December 31.....	--	5.13%	7.44%

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

The Company has three special purpose entities “SPE’s” which are consolidated into the Company’s financial statements and were formed for the exclusive purpose of raising capital through the issuance of Mandatorily Redeemable Trust Preferred Securities. For financial reporting purposes, the Subordinated Debentures and related trust investments in the Subordinated Debentures have been eliminated in consolidation and the Trust Preferred Securities are included in the consolidated balance sheet. Under applicable regulatory guidelines all of the Trust Preferred Securities currently qualify as Tier I capital.

#### ***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 7/8% 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 7/8%, 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 7/8 % of the liquidation amount of \$1,000 per security. The distributions on the trust preferred 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 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.

Holder 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 distributions on the trust preferred 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 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 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%), the current interest rate is 5.75%, 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 mandatorily 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.

Holder 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 of 5.75%); 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 (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, 2001 and 2000 was 19,000,000 and 14,000,000, respectively. The amount of deferred costs at December 31, 2001 and 2000 was \$548,000 and \$413,000, respectively. The amortization of the deferred costs at December 31, 2001 and 2000 was \$16,000 and \$7,000, respectively.

## (9) INCOME TAXES

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

(Dollars in thousands)	December 31,		
	2001	2000	1999
Current:			
Federal.....	\$ 534	\$ 2,052	\$ 2,512
State.....	1,425	606	803
Total current.....	<u>1,959</u>	<u>2,658</u>	<u>3,315</u>
Deferred:			
Federal.....	1,911	184	(640)
State.....	540	207	(69)
Total deferred.....	<u>2,451</u>	<u>391</u>	<u>(709)</u>
Provision for income taxes.....	<u>\$ 4,410</u>	<u>\$ 3,049</u>	<u>\$ 2,606</u>

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

	December 31,		
	2001	2000	1999
Statutory federal income tax rate.....	35.0 %	35.0 %	35.0 %
State income taxes, net of federal tax benefit.....	4.9	3.1	6.6
Merger cost.....	--	6.9	--
Non-taxable interest income.....	(2.2)	(3.2)	(3.2)
Officers' life insurance.....	(3.0)	(3.1)	(1.9)
Other.....	3.1	(2.7)	(0.7)
Effective tax rate.....	<u>37.8 %</u>	<u>36.0 %</u>	<u>35.8 %</u>

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

(Dollars in thousands)	<b>December 31,</b>	
	<b>2001</b>	<b>2000</b>
Deferred tax assets:		
Allowance for loan losses.....	\$ 4,546	\$ 3,491
Accrued expenses.....	1,142	8
State income taxes.....	484	91
Securities available-for-sale.....	--	--
Net operating loss carryforward.....	396	519
Other.....	511	106
Total deferred tax assets.....	<u>7,079</u>	<u>4,215</u>
Deferred tax liabilities:		
Securities available-for-sale.....	(609)	(332)
Loan fees.....	(143)	(172)
State income taxes.....	--	--
Other.....	(596)	(154)
Total deferred tax liabilities.....	<u>(1,348)</u>	<u>(658)</u>
Net deferred tax assets.....	<u>\$ 5,731</u>	<u>\$ 3,557</u>

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 \$1,166,000 for federal income tax purposes and zero for California. The federal net operating losses expire in 2005. These loss related to the entity that was the predecessor of the Bank of Los Altos, 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 \$290,000

## (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 of grant. Future grants under the Plan equal 438,724 shares as of December 31, 2001. Option activity under the Plan is as follows:

	<b>Number of Shares</b>	<b>Weighted Average Exercise Price</b>
<b>Options Outstanding at January 1, 1999</b>		
(1,195,274 exercisable at a weighted average exercise price of \$4.58).....	1,834,528	\$ 5.23
Granted (weighted average fair value of \$6.46).....	255,634	\$ 12.68
Exercised.....	(109,467)	\$ 4.07
Cancelled.....	(24,461)	\$ 7.96
<b>Options Outstanding at December 31, 1999</b>		
(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.....	(66,070)	\$ 9.14
<b>Options Outstanding at December 31, 2000</b>		
(1,086,985 exercisable at 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.....	(32,840)	\$ 10.78
<b>Options Outstanding at December 31, 2001</b>		
(1,148,381 exercisable at weighted average exercise price of \$7.69).....	<u>1,546,651</u>	\$ 8.25

Additional information regarding options outstanding under the Plan as of December 31, 2001 is as follows:

<b>Range of Exercise Prices</b>	<b>Number Outstanding</b>	<b>Remaining Contractual Life (Yrs.)</b>	<b>Average Exercise Price</b>	<b>Number Exercisable</b>	<b>Average Exercise Price</b>
\$ 1.42 - \$4.41.....	408,439	3.08	\$ 2.86	408,439	\$ 2.86
\$ 4.42 - \$5.32.....	62,128	5.46	\$ 5.23	62,128	\$ 5.23
\$ 5.33 - \$9.70.....	532,164	7.85	\$ 8.84	303,109	\$ 9.08
\$ 9.71 - \$16.37.....	543,920	7.53	\$ 12.05	374,705	\$ 12.23
\$ 1.42 - \$16.37.....	<u>1,546,651</u>	6.38	\$ 8.25	<u>1,148,381</u>	\$ 7.69

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.

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, 1.7% for 2001, 5.7% for 2000, and 5.5% for 1999; stock volatility of 31% in 2001, and 35% in 2000, and 39% in 1999; 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.

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:

(Amounts in thousands, except per share data)	Years ended December 31,		
	2001	2000	1999
Net income			
As reported.....	\$ 7,268	\$ 5,429	\$ 4,669
Pro forma.....	\$ 6,643	\$ 4,835	\$ 4,171
Net income per common share - basic			
As reported.....	\$ 0.66	\$ 0.51	\$ 0.47
Pro forma.....	\$ 0.60	\$ 0.46	\$ 0.42
Net income per common share - diluted			
As reported.....	\$ 0.64	\$ 0.49	\$ 0.43
Pro forma.....	\$ 0.58	\$ 0.44	\$ 0.38

## (11) 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:

(Amounts in thousands)	
Year ending December 31,	
2002.....	\$ 2,091
2003.....	2,039
2004.....	2,023
2005.....	1,905
2006.....	1,819
Thereafter.....	5,073
Total.....	\$ <u>14,950</u>

Rent expense under operating leases was \$2,201,000, \$1,676,000, and \$1,387,000, during the years ended December 31, 2001, 2000, and 1999. Rent expense was reduced by deferred rent concessions on one of the Company's locations of \$46,000 for the years ended December 31, 2001, 2000, and 1999.

## (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 2001) to the plan through salary deductions under 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 in 2001 were \$313,000.

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 2001 and 2000, the Company made contributions of \$244,000 and \$250,000 into the plan. The amount contributed into this plan 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 shall be due and payable. An annual rate of interest, equal to Prime rate plus 0.50% floating on a daily basis, shall be 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 122,000 shares of the Company's common stock held by the ESOP. At December 31, 2001, the ESOP owned approximately 199,000 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 \$192,000 and \$200,000 as of December 31, 2001 and 2000 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 (\$22,034,000 and \$15,983,000 at December 31, 2001 and 2000, respectively) to pay the retirement obligations. The accrued pension obligation was \$2,596,000 and \$2,125,000 as of December 31, 2001 and 2000, respectively, and is included in "Accrued interest payable and other liabilities".

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

(Amounts in thousands)	2001	2000
Change in projected benefit obligation		
Projected benefit obligation at beginning of year.....	\$ 2,150	\$ 253
Service cost.....	378	1,879
Interest cost.....	113	18
Actuarial gain.....	(242)	--
Projected benefit obligation at end of year.....	\$ 2,399	\$ 2,150

(Amounts in thousands)	2001	2000
<b>Change in Plan assets</b>		
Fair value of Plan assets at beginning of year.....	\$ --	\$ --
Fair value of Plan assets at end of year.....	\$ --	\$ --
<b>Funding</b>		
Unfunded Status.....	\$ (2,399)	\$ (2,150)
Unrecognized net actuarial (gain)/loss.....	(192)	25
Accrued pension cost.....	<u>\$ (2,591)</u>	<u>\$ (2,125)</u>
<b>Weighted-average assumptions as of December 31</b>		
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, was as follows:

(Amounts in thousands)	2001	2000
<b>Components of net periodic benefits cost</b>		
Service cost.....	\$ 378	\$ 1,879
Interest cost.....	113	18
Amortization of gains.....	(25)	--
Net periodic benefit cost.....	<u>\$ 466</u>	<u>\$ 1,897</u>

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

	2001	2000
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 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, 2001 and 2000 were as follows:

(Amounts in thousands)	2001		2000	
	Carrying Amounts	Estimated Fair Value	Carrying Amounts	Estimated Fair Value
<b>Assets</b>				
Cash and cash equivalents.....	\$ 106,319	\$ 106,319	\$ 60,069	\$ 60,069
Securities.....	106,810	107,242	110,802	110,969
Loans, including loans held for sale, net.....	654,224	657,336	637,061	639,365
Other investments.....	24,779	24,779	18,957	18,957
<b>Liabilities</b>				
Time deposits.....	\$ 290,748	\$ 295,732	\$ 242,415	\$ 243,184
Other deposits.....	517,160	517,160	495,771	495,771
Federal Home Loan Bank borrowings.....	--	--	18,000	18,000
Mandatorily redeemable cumulative trusts preferred securities.....	19,000	19,727	14,000	14,000

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 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.

***FHLB Borrowing***

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

***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.

The Banks' 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. The Banks use 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. The Banks' control 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>2001</u>	<u>2000</u>
Commitments to extend credit.....	\$ 275,796	\$ 351,401
Standby letters of credit.....	2,526	6,792
	<u>\$ 278,322</u>	<u>\$ 358,193</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. The Banks evaluate each client's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Banks 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 the Banks 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*

In 1992 and for a period prior thereto, a former officer and director of Bank of Los Altos served as a director of Pacific National Financial Company (PNFC), a Canadian corporation, when a PNFC subsidiary was Bank of Los Altos's parent company. In December 1998, Bank of Los Altos received a request for indemnity from the former officer under an indemnity agreement entered into by Bank of Los Altos in December 1992. The request for indemnity relates to three complaints filed in July 1998 naming the former officer and seven other former directors of PNFC and seeks damages of \$166 million (\$Canadian 240 million) arising from their role as PNFC directors. The largest of the three actions alleges that the defendants breached their fiduciary duties to PNFC, resulting in its 1992 bankruptcy. The former officer has requested that Bank of Los Altos pay for his defense and indemnify him in connection with such actions. Although Bank of Los Altos has reserved its rights under the indemnity agreement, it has conditionally agreed to be responsible for payment of the former officer's defense costs. Following service of the complaints in December, 1998, Bank of Los Altos has been informed by counsel that there has been no effort to prosecute the cases by the plaintiffs or any communications from plaintiffs stating an intent to proceed with the litigation. Based on the representations of the former officer and discussions with legal counsel, management and the Board of Directors of the Company and Bank of Los Altos have no reason to believe that the indemnification will result in any material effect on the financial statements of the Company.

In addition to the above, the Company is involved in a number of 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.

## **(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 the Banks must meet specific capital guidelines that involve quantitative measures of the Company's and the Banks' assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Company's and the Banks' 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 the Banks 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, 2001, the Company and the Banks meets all capital adequacy guidelines to which it is subject.

The most recent notification from the FDIC for the Banks as of December 31, 2001 and 2000 categorized HBC, HBEB, HBSV, and BLA as "well capitalized" under the regulatory framework for prompt corrective action. To be categorized as "well capitalized" the Banks 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.

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

(Dollars in thousands)	Actual		For Capital Adequacy Purposes	
	Amount	Ratio	Amount	Ratio
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%
As of December 31, 2000				
Total Capital..... (to risk-weighted assets)	\$ 88,409	11.7%	\$ 60,451	(greater than or equal to) 8.0%
Tier 1 Capital..... (to risk-weighted assets)	\$ 78,982	10.5%	\$ 30,088	(greater than or equal to) 4.0%
Tier 1 Capital..... (to average assets)	\$ 78,982	9.3%	\$ 33,971	(greater than or equal to) 4.0%

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

(Dollars in thousands)	Actual		For Capital Adequacy Purposes		To Be Well-Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
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%
As of December 31, 2000						
Total Capital..... (to risk-weighted assets)	\$ 44,148	10.3%	\$ 34,290	(greater than or equal to) 8.0%	\$ 42,862	(greater than or equal to) 10.0%
Tier 1 Capital..... (to risk-weighted assets)	\$ 38,800	9.1%	\$ 17,055	(greater than or equal to) 4.0%	\$ 25,582	(greater than or equal to) 6.0%
Tier 1 Capital..... (to average assets)	\$ 38,800	8.3%	\$ 18,699	(greater than or equal to) 4.0%	\$ 23,374	(greater than or equal to) 5.0%

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

(Dollars in thousands)	Actual		For Capital Adequacy Purposes		To Be Well-Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
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%
As of December 31, 2000						
Total Capital..... (to risk-weighted assets)	\$ 8,704	10.9%	\$ 6,388	(greater than or equal to) 8.0%	\$ 7,985	(greater than or equal to) 10.0%
Tier 1 Capital..... (to risk-weighted assets)	\$ 7,734	9.7%	\$ 3,189	(greater than or equal to) 4.0%	\$ 4,784	(greater than or equal to) 6.0%
Tier 1 Capital..... (to average assets)	\$ 7,734	8.6%	\$ 3,597	(greater than or equal to) 4.0%	\$ 4,497	(greater than or equal to) 5.0%

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

(Dollars in thousands)	Actual		For Capital Adequacy Purposes		To Be Well-Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
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%
As of December 31, 2000						
Total Capital..... (to risk-weighted assets)	\$ 7,335	15.5%	\$ 3,786	(greater than or equal to) 8.0%	\$ 4,732	(greater than or equal to) 10.0%
Tier 1 Capital..... (to risk-weighted assets)	\$ 6,777	14.4%	\$ 1,883	(greater than or equal to) 4.0%	\$ 2,824	(greater than or equal to) 6.0%
Tier 1 Capital..... (to average assets)	\$ 6,777	13.7%	\$ 1,979	(greater than or equal to) 4.0%	\$ 2,473	(greater than or equal to) 5.0%

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

(Dollars in thousands)	Actual		For Capital Adequacy Purposes		To Be Well-Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
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%
As of December 31, 2000						
Total Capital..... (to risk-weighted assets)	\$ 21,476	10.9%	\$ 15,762	(greater than or equal to) 8.0%	\$ 19,703	(greater than or equal to) 10.0%
Tier 1 Capital..... (to risk-weighted assets)	\$ 19,218	9.8%	\$ 7,844	(greater than or equal to) 4.0%	\$ 11,766	(greater than or equal to) 6.0%
Tier 1 Capital..... (to average assets)	\$ 19,218	7.6%	\$ 10,115	(greater than or equal to) 4.0%	\$ 12,643	(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, 2001 and 2000, the Company maintained reserves of \$10,492,000 and \$7,224,000 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 Commissioner may order a bank to refrain from making such a proposed distribution. At December 31, 2001, the amount available for such dividend without prior written approval was approximately \$10,675,000 for HBC, zero for HBEB, zero for HBSV, and \$6,313,000 for BLA. Similar restrictions apply to the amounts and sum of loans advances and other transfers of funds from the banks 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

(Amounts in thousands)	December 31,	
	2001	2000
Cash and cash equivalents.....	\$ 5,747	\$ 5,746
Investment in and advancements to subsidiaries.....	87,106	73,476
Other assets.....	2,963	2,540
Total.....	<u>\$ 95,816</u>	<u>\$ 81,762</u>
Liabilities.....	\$ 1,664	\$ 1,606
Amounts due to nonbank subsidiaries.....	19,578	14,423
Shareholders' equity.....	74,574	65,733
Total.....	<u>\$ 95,816</u>	<u>\$ 81,762</u>

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### CONDENSED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

(Amounts in thousands)	For the Years Ended,		
	December 31, 2001	December 31, 2000	December 31, 1999
Dividends from Bank subsidiaries.....	\$ --	\$ 250	\$ --
Interest income.....	141	243	204
Management and service fees.....	8,573	6,995	--
Other income.....	--	100	--
Interest expense.....	--	(2)	(16)
Other expenses.....	(12,923)	(10,552)	(61)
Income (loss) before equity in net income of subsidiary banks.....	(4,209)	(2,966)	127
Equity in undistributed net income of subsidiaries.....	9,897	7,218	4,582
Income tax benefit (expense).....	1,580	1,177	(40)
Net income.....	<u>7,268</u>	<u>5,429</u>	<u>4,669</u>
Other comprehensive income.....	506	1,769	(1,796)
Comprehensive income.....	<u>\$ 7,774</u>	<u>\$ 7,198</u>	<u>\$ 2,873</u>

## CONDENSED STATEMENTS OF CASH FLOWS

(Amounts in thousands)	For the Years Ended,		
	December 31, 2001	December 31, 2000	December 31, 1999
Cash flows from operating activities:			
Net Income.....	\$ 7,268	\$ 5,429	\$ 4,669
Adjustments to reconcile net income to net cash provided by (used in) operations:			
Provision for deferred income taxes.....	(1,580)	(1,177)	40
Equity in undistributed losses of subsidiaries.....	(9,897)	(7,218)	(4,582)
Net change in other assets.....	84	(1,177)	(21)
Net change in other liabilities.....	809	1,653	(31)
Net cash provided by (used in) by operating activities	<u>(3,316)</u>	<u>(2,490)</u>	<u>75</u>
Cash flows from investing activities:			
Other (dividends received from Bank subsidiaries).....	--	(17,079)	(250)
Cash distributed to Bank subsidiaries.....	(2,750)	--	(2,985)
Net cash used in investing activities	<u>(2,750)</u>	<u>(17,079)</u>	<u>(3,235)</u>
Cash flows from financing activities:			
Proceeds from issuance of common stock.....	1,067	1,991	11,681
Proceeds from issuance of long-term debt.....	5,000	14,000	--
Proceeds from other short-term borrowings.....	--	--	4,000
Repayments of other short-term borrowings.....	--	(2,000)	(2,000)
Net cash provided by financing activities.....	<u>6,067</u>	<u>13,991</u>	<u>13,681</u>
Net increase (decrease) in cash and cash equivalents.....	1	(5,578)	10,521
Cash and cash equivalents, beginning of year.....	5,746	11,324	803
Cash and cash equivalents, end of year.....	<u>\$ 5,747</u>	<u>\$ 5,746</u>	<u>\$ 11,324</u>

## EXHIBIT INDEX

### Incorporated by Reference to Form

	<u>Filed Here with</u>	<u>8-A Dated</u>	<u>10-Q Dated</u>	<u>10-K Dated</u>	<u>Exhibit No.</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			6-30-01		3.1
3.2			9-30-01		3.2
4.1				4-6-01  (10-K/A Amendment No. 1)	4.1
4.2				4-6-01  (10-K/A Amendment No. 1)	4.2
4.3				4-6-01  (10-K/A Amendment No. 1)	4.3
4.4				4-6-01  (10-K/A Amendment No. 1)	4.4
4.5		11-15-01			4
4.6	X				4.6
4.7	X				4.7

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	
23.2	Consent of Arthur Andersen LLP	X	

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