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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-K

(MARK ONE)

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

For the fiscal year ended December 31, 2022

OR

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

FOR THE TRANSITION PERIOD FROM TO

Commission file number 000-23877

Heritage Commerce Corp

(Exact name of Registrant as Specified in its Charter)

California
(State or Other Jurisdiction of
Incorporation or Organization)

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

224 Airport Parkway
San Jose, California 95110
(Address of Principal Executive Offices including Zip Code)

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

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

Title of Each Class	Trading Symbol	Name of each exchange on which Registered
Common Stock, No Par Value	HTBK	The NASDAQ Stock Market LLC (NASDAQ Global Select Market)

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

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

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

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

Indicate by check mark whether the registrant has submitted electronically, every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the Registrant was required to submit and post such files). Yes No

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company
Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant has filed a report on and attestation to its management's assessment of the effectiveness of its internal control over financial reporting under Section 404(b) of the Sarbanes-Oxley Act (15 U.S.C.7262(b)) by the registered public accounting firm that prepared or issued its audit report.

If securities are registered pursuant to Section 12(b) of the Act, indicate by check mark whether the financial statements of the registrant included in the filing reflect the correction of an error to previously issued financial statements.

Indicate by check mark whether any of those error corrections are restatements that required a recovery analysis of incentive-based compensation received by any of the registrant's executive officers during the relevant recovery period pursuant to §240.10D-1(b).

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

The aggregate market value of the common stock held by non-affiliates of the Registrant as of June 30, 2022, based upon the closing price on that date of \$10.69 per share as reported on the NASDAQ Global Select Market, and 47,503,819 shares held, was approximately \$507.8 million.

As of February 9, 2023, there were 60,897,655 shares of the Registrant's common stock (no par value) outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's definitive proxy statement to be filed with the Securities and Exchange Commission pursuant to Regulation 14A in connection with the 2023 Annual Meeting of Shareholders to be held on May 25, 2023 are incorporated by reference into Part III of this Report. The proxy statement will be filed with the Securities and Exchange Commission not later than 120 days after the Registrant's fiscal year ended December 31, 2022.

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Cautionary Note Regarding Forward-Looking Statements

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

These forward looking statements are subject to various risks and uncertainties that may be outside our control and our actual results could differ materially from our projected results. Risks and uncertainties that could cause our financial performance to differ materially from our goals, plans, expectations and projections expressed in forward-looking statements include those set forth in our filings with the Securities and Exchange Commission ("SEC"), Item 1A of this Annual Report on Form 10-K, and the following listed below:

- geopolitical and domestic political developments that can increase levels of political and economic unpredictability, contribute to rising energy and commodity prices, and increase the volatility of financial markets;
- current and future economic and market conditions in the United States generally or in the communities we serve, including the effects of declines in property values and overall slowdowns in economic growth should these events occur;
- effects of and changes in trade, monetary and fiscal policies and laws, including the interest rate policies of the Federal Open Market Committee of the Federal Reserve Board;
- inflationary pressures and changes in the interest rate environment that reduce our margins and yields, the fair value of financial instruments or our level of loan originations, or increase the level of defaults, losses and prepayments on loans we have made and make, whether held in the portfolio or in the secondary market;
- changes in the level of nonperforming assets and charge offs and other credit quality measures, and their impact on the adequacy of our allowance for credit losses and our provision for credit losses;
- volatility in credit and equity markets and its effect on the global economy;
- conditions relating to the impact of the COVID-19 pandemic, and other infectious illness outbreaks that may arise in the future, our customers, employees, businesses, liquidity, financial results and overall condition including severity and duration of the associated uncertainties in U.S. and global markets;
- our ability to effectively compete with other banks and financial services companies and the effects of competition in the financial services industry on our business;
- our ability to achieve loan growth and attract deposits in our market area, the impact of the cost of deposits and our ability to retain deposits;
- risks associated with concentrations in real estate related loans;

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- the relative strength or weakness of the commercial and real estate markets where our borrowers are located, including related vacancy rates, and asset and market prices;
- credit related impairment charges to our securities portfolio;
- increased capital requirements for our continual growth or as imposed by banking regulators, which may require us to raise capital at a time when capital is not available on favorable terms or at all;
- regulatory limits on Heritage Bank of Commerce's ability to pay dividends to the Company;
- operational issues stemming from, and/or capital spending necessitated by, the potential need to adapt to industry changes in information technology systems, on which we are highly dependent;
- our inability to attract, recruit, and retain qualified officers and other personnel could harm our ability to implement our strategic plan, impair our relationships with customers and adversely affect our business, results of operations and growth prospects;
- possible adjustment of the valuation of our deferred tax assets;
- our ability to keep pace with technological changes, including our ability to identify and address cyber-security risks such as data security breaches, “denial of service” attacks, “hacking” and identity theft;
- inability of our framework to manage risks associated with our business, including operational risk and credit risk;
- risks of loss of funding of Small Business Administration (“SBA”) or SBA loan programs, or changes in those programs;
- compliance with applicable laws and governmental and regulatory requirements, including the Dodd-Frank Act and others relating to banking, consumer protection, securities, accounting and tax matters;
- effect of changes in accounting policies and practices, as may be adopted by the regulatory agencies, as well as the Public Company Accounting Oversight Board, the Financial Accounting Standards Board and other accounting standard setters;
- the expense and uncertain resolution of litigation matters whether occurring in the ordinary course of business or otherwise;
- availability of and competition for acquisition opportunities;
- risks resulting from domestic terrorism;
- risks resulting from social unrest and protests;
- risks of natural disasters (including earthquakes, fires, and flooding) and other events beyond our control; and
- our success in managing the risks involved in the foregoing factors.

Forward-looking statements speak only as of the date they are made. The Company does not undertake to update forward-looking statements to reflect circumstances or events that occur after the date the forward-looking statements are made or to reflect the occurrence of unanticipated events. *You should consider any forward looking statements in light of this explanation, and we caution you about relying on forward-looking statements.*

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PART I

ITEM 1. BUSINESS

General

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

Heritage Bank of Commerce is a multi-community independent bank that offers a full range of commercial banking services to small and medium-sized businesses and their owners, managers and employees. We operate through 18 full service branch offices located entirely in the general San Francisco Bay Area of California in the counties of Alameda, Contra Costa, Marin, San Benito, San Francisco, San Mateo, and Santa Clara. Our market includes the headquarters of a number of technology based companies in the region commonly known as “Silicon Valley.”

Our lending activities are diversified and include commercial, real estate, construction and land development, consumer and Small Business Administration (“SBA”) guaranteed loans. We generally lend in markets where we have a physical presence through our branch offices. We attract deposits throughout our market area with a customer-oriented product mix, competitive pricing, and convenient locations. We offer a wide range of deposit products for business banking and retail markets. We offer a multitude of other products and services to complement our lending and deposit services. In addition, Bay View Funding provides factoring financing throughout the United States.

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

Our principal executive office is located at 224 Airport Parkway, San Jose, California 95110, telephone number: (408) 947-6900.

At December 31, 2022, we had consolidated assets of \$5.158 billion, deposits of \$4.390 billion and shareholders’ equity of \$632.5 million.

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

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

Heritage Bank of Commerce

HBC is a California state-chartered bank headquartered in San Jose, California. It was incorporated in November 1993 and opened for business in June 1994. HBC operates through eighteen* full service branch

offices. The locations of HBC's current offices and the administrative office of CSNK Working Capital Finance Corp. d/b/a Bay View Funding ("Bay View Funding") are:

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San Jose:	Administrative Office Main Branch 224 Airport Parkway, Suite 100 San Jose, CA 95110	Los Altos:	Branch Office 419 South San Antonio Road Los Altos, CA 94022
Danville:	Branch Office 387 Diablo Road Danville, CA 94526	Los Gatos:	Branch Office 15575 Los Gatos Boulevard Suite B Los Gatos, CA 95032
Fremont:	Branch Office 3137 Stevenson Boulevard Fremont, CA 94538	Morgan Hill:	Branch Office 18625 Sutter Boulevard Suite 100 Morgan Hill, CA 95037
Gilroy:	Branch Office 7598 Monterey Street Suite 110 Gilroy, CA 95020	Oakland:	Branch Office 1111 Broadway Suite 1650 Oakland, CA 94607
Hollister:	Branch Office 351 Tres Pinos Road Suite 102A Hollister, CA 95023	Palo Alto:	Branch Office 325 Lytton Avenue Suite 100 Palo Alto, CA 94301
Livermore	Branch Office 1987 First Street Livermore, CA 94550	Pleasanton:	Branch Office 300 Main Street Pleasanton, CA 94566
Redwood City:	Branch Office 2400 Broadway Suite 100 Redwood City, CA 94063	Sunnyvale:*	Branch Office 333 W. El Camino Real Suite 150 Sunnyvale, CA 94087
San Francisco:	Branch Office 120 Kearny Street Suite 2300 San Francisco, CA 94108	Walnut Creek:	Branch Office 1990 N. California Boulevard Suite 100 Walnut Creek, CA 94596
San Mateo:	Branch Office 400 S. El Camino Real Suite 150 San Mateo, CA 94402	Bay View Funding	Administrative Office 224 Airport Parkway Suite 200 San Jose, CA 95110
San Rafael:	Branch Office 999 5th Avenue Suite 100 San Rafael, CA 94901		

*The Sunnyvale branch office is closing on April 28, 2023.

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Lending Activities

We offer a diversified mix of business loans encompassing the following loan products: (i) commercial and industrial loans; (ii) commercial real estate loans; (iii) construction loans; and (iv) SBA loans. From time to time the Company has purchased single family residential mortgage loans. We also offer home equity lines of credit (“HELOCS”), to accommodate the needs of business owners and individual clients, as well as consumer loans (both secured and unsecured). In the event creditworthy loan customers’ borrowing needs exceed our legal lending limit, we have the ability to sell participations in those loans to other banks. We encourage relationship banking, obtaining a substantial portion of each borrower’s banking business, including deposit accounts.

As of December 31, 2022, the percentage of our total loans for each of the principal areas in which we directed our lending activities were as follows: (i) commercial and industrial loans 16% (including SBA loans, SBA Paycheck Protection Program (“PPP”) loans, asset-based lending, and factored receivables); (ii) commercial real estate loans 51%; (iii) land and construction loans 5%; (iv) residential mortgage loans 16%; and (v) consumer and other loans (including home equity and multifamily loans) 12%. While no specific industry concentration is considered significant, our lending operations are located in market areas dependent on technology and real estate industries and their supporting companies.

Commercial and Industrial Loans. Our commercial loan portfolio is comprised of operating secured and unsecured loans advanced for working capital, equipment purchases and other business purposes. Generally short-term loans have maturities ranging from thirty days to one year, and “term loans” have maturities ranging from one to five years. Short-term business loans are generally intended to finance current transactions and typically provide for periodic principal payments, with interest payable monthly. Term loans generally provide for floating or fixed interest rates, with monthly payments of both principal and interest. Repayment of secured and unsecured commercial loans depends substantially on the borrower’s underlying business, financial condition and cash flows, as well as the sufficiency of the collateral. Compared to real estate, the collateral may be more difficult to monitor, evaluate and sell. It may also depreciate more rapidly than real estate. Such risks can be significantly affected by economic conditions.

Our factored receivables portfolio is originated by Bay View Funding. Factored receivables are receivables that have been acquired from the originating company and typically have not been subject to previous collection efforts. These receivables are acquired from a variety of companies, including but not limited to service providers, transportation companies, manufacturers, distributors, wholesalers, apparel companies, advertisers, and temporary staffing companies. The average life of the factored receivables was 38 days for the year ended December 31, 2022.

HBC’s commercial loans, except for the asset-based lending and the factored receivables at Bay View Funding, are primarily originated from locally-oriented commercial activities in communities where HBC has a physical presence through its branch offices.

Commercial Real Estate Loans. The commercial real estate (“CRE”) loan portfolio is comprised of loans secured by commercial real estate. Commercial real estate loans comprise two segments differentiated by owner occupied commercial real estate and non-owner commercial real estate. Owner occupied commercial real estate loans are secured by commercial properties that are at least 50% occupied by the borrower or borrower affiliate. Non-owner occupied commercial real estate loans are secured by commercial properties that are less than 50% occupied by the borrower or borrower affiliate. Commercial real estate loans may be adversely affected by conditions in the real estate markets or in the general economy. These loans are generally advanced based on the borrower’s cash flow, and the underlying collateral provides a secondary source of payment. HBC generally restricts real estate term loans to no more than 75% of the property’s appraised value or the purchase price of the property, depending on the type of property and its utilization. HBC offers both fixed and floating rate loans. Maturities on such loans are generally restricted to between five and ten years (with amortization ranging from fifteen to twenty-five years and a balloon payment due at maturity); however, SBA and certain real estate loans that can be sold in the secondary market may be advanced for longer maturities. CRE loans typically involve large balances to single borrowers or groups of related borrowers. Since payments on these loans are often dependent on the successful operation or

management of the properties, as well as the business and financial condition of the borrower, repayment of such loans may be subject to adverse conditions in the real estate market, adverse economic conditions or changes in applicable government regulations. If the cash flow from the project decreases, or if leases are not obtained or renewed, the borrower's ability to repay the loan may be impaired.

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Construction Loans. We make commercial construction loans for rental properties, commercial buildings and homes built by developers on speculative, undeveloped property. We also make construction loans for homes and commercial buildings built by owner occupants. The terms of commercial construction loans are made in accordance with our loan policy. Advances on construction loans are made in accordance with a schedule reflecting the cost of construction, but are generally limited to a 70% loan-to-value ratio, as completed. Repayment of construction loans on non-residential properties is normally expected from the property's eventual rental income, income from the borrower's operating entity or the sale of the subject property. In the case of income-producing property, repayment is usually expected from permanent financing upon completion of construction. At times we provide the permanent mortgage financing on our construction loans on income-producing property. Construction loans are interest-only loans during the construction period, which typically do not exceed 18 months. If HBC provides permanent financing the short-term loan converts to permanent, amortizing financing following the completion of construction. Generally, before making a commitment to fund a construction loan, we require an appraisal of the property by a state-certified or state-licensed appraiser. We review and inspect properties before disbursement of funds during the term of the construction loan. The repayment of construction loans is dependent upon the successful and timely completion of the construction of the subject property, as well as the sale of the property to third parties or the availability of permanent financing upon completion of all improvements. Construction loans expose us to the risk that improvements will not be completed on time, and in accordance with specifications and projected costs. Construction delays, the financial impairment of the builder, interest rate increases or economic downturn may further impair the borrower's ability to repay the loan. In addition, the borrower may not be able to obtain permanent financing or ultimate sale or rental of the property may not occur as anticipated. HBC utilizes underwriting guidelines to assess the likelihood of repayment from sources such as sale of the property or permanent mortgage financing prior to making the construction loan.

SBA Loans. SBA loans are made through programs designed by the federal government to assist the small business community in obtaining financing from financial institutions that are given government guarantees as an incentive to make the loans. HBC has been designated as an SBA Preferred Lender. Our SBA loans fall into four categories: loans originated under the SBA's 7a Program ("7a Loans"); loans originated under the SBA's 504 Program ("504 Loans"); SBA "Express" Loans, and U.S. Department of Agriculture guaranteed lending programs. SBA 7a Loans are commercial business loans generally made for the purpose of purchasing real estate to be occupied by the business owner, providing working capital, and/or purchasing equipment or inventory. SBA 504 Loans are collateralized by commercial real estate and are generally made to business owners for the purpose of purchasing or improving real estate for their use and for equipment used in their business. The SBA "Express" Loans or lines of credit are for businesses that want to improve cash flow, refinance debt, or fund improvements, equipment, or real estate. It features an abbreviated SBA application process and accelerated approval times, plus it can offer longer terms and lower down payment requirements than conventional loans.

SBA lending is subject to federal legislation that can affect the availability and funding of the program. From time to time, this dependence on legislative funding causes limitations and uncertainties with regard to the continued funding of such programs, which could potentially have an adverse financial impact on our business.

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

Multifamily Loans. Multifamily loans are loans on residential properties with five or more units. These loans rely primarily on the cash flows of the properties securing the loan for repayment and secondarily on the value of the properties securing the loan. The cash flows of these borrowers can fluctuate along with the values of the underlying property depending on general economic conditions.

Residential Mortgage Loans. From time to time the Company has purchased single family residential mortgage loans. Residential mortgage loans outstanding at December 31, 2022 totaled \$537.9 million. During the year ended December 31, 2022, the Company purchased single family residential mortgage loans totaling \$185.4 million, tied to homes all located in California, with average principal balances of approximately \$934,000. HBC does not originate first trust deed home mortgage loans or home improvement loans, other than HELOCs.

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

Deposit Products

As a full-service commercial bank, we focus deposit generation on relationship accounts, encompassing non-interest bearing demand, interest bearing demand, and money market accounts. In order to facilitate the generation of non-interest bearing demand deposits, we require, depending on the circumstances and the type of relationship, our borrowers to maintain deposit balances with us as a typical condition of granting loans. We also offer certificates of deposit and savings accounts. We offer a "remote deposit capture" product that allows deposits to be made via computer at the customer's business location. We also offer customers "e-statements" that allows customers to receive statements electronically, which is more convenient and secure than receiving paper statements.

For customers requiring full Federal Deposit Insurance Corporation ("FDIC") insurance on certificates of deposit in excess of \$250,000, we offer the Certificate of Deposit Account Registry Service ("CDARS") program, which allows HBC to place the certificates of deposit with other participating banks to maximize the customers' FDIC insurance. HBC also receives reciprocal deposits from other participating financial institutions.

Electronic Banking

While personalized, service-oriented banking is the cornerstone of our business plan, we use technology and the Internet as a secondary means for servicing customers, to compete with larger banks and to provide a convenient platform for customers to review and transact business. We offer sophisticated electronic or "internet banking" opportunities that permit commercial customers to conduct much of their banking business remotely from their home or business. However, our customers will always have the opportunity to personally discuss specific banking needs with knowledgeable bank officers and staff who are directly accessible in the branches and offices as well as by telephone and email.

HBC offers multiple electronic banking options to its customers. It does not allow the origination of deposit accounts through online banking. All of HBC's electronic banking services allow customers to review transactions and statements, review images of paid items, transfer funds between accounts at HBC, place stop orders, pay bills and export to various business and personal software applications. HBC online commercial banking also allows customers to initiate domestic wire transfers and ACH transactions, with the added security and functionality of assigning discrete access and levels of security to different employees of the client and division of functions to allow separation of duties, such as input and release.

We also offer our internet banking customers an additional third party product designed to assist in mitigating fraud risk to both the customer and the Bank in internet banking and other internet activities conducted by the customer, at no cost to the customer.

Other Banking Services

We offer a multitude of other products and services to complement our lending and deposit services. These include cashier's checks, bank by mail, night depositories, safe deposit boxes, direct deposit, automated payroll services, electronic funds transfers, online bill pay, homeowner association services, and other customary banking services. HBC currently operates ATMs at six different locations. In addition, we have established a convenient customer service group accessible by toll free telephone to answer questions and

promote a high level of customer service. HBC does not have a trust department. In addition to the traditional financial services offered, HBC offers remote deposit capture, automated clearing house origination, electronic data interchange and check imaging. HBC continues to investigate products and

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services that it believes addresses the growing needs of its customers and to analyze other markets for potential expansion opportunities.

Investments

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

Sources of Funds

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

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

On May 11, 2022, the Company completed a private placement offering of \$40.0 million aggregate principal amount of its 5.00% fixed-to-floating rate subordinated notes due May 15, 2032 (“Sub Debt due 2032”). The Company used the net proceeds of the Sub Debt due 2032 for general corporate purposes, including the repayment on June 1, 2022 of the Company’s \$40.0 million aggregate principal amount of 5.25% fixed-to-floating rate subordinated notes due June 1, 2027 (“Sub Debt due 2027”). The Sub Debt due 2032, net of unamortized issuance costs of \$650,000, totaled \$39.4 million at December 31, 2022, and qualifies as Tier 2 capital for the Company under the guidelines established by the Federal Reserve Bank

On May 26, 2017, the Company completed an underwritten public offering of \$40.0 million aggregate principal amount of its Sub Debt due 2027. The Sub Debt due 2027 had a fixed interest rate of 5.25% per year through June 1, 2022. On June 1, 2022, the Company completed the redemption of all of its outstanding \$40.0 million of Sub Debt due 2027, prior to resetting to a floating rate. The Sub Debt due 2027 was redeemed pursuant to the terms of the Subordinated Indenture, as supplemented by the First Supplemental Indenture, each dated as of May 26, 2017, between the Company and Wilmington Trust, National Association, as Trustee, at the redemption price of 100% of its principal amount, plus accrued and unpaid interest of \$1.1 million.

Correspondent Banks

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

Competition

The banking and financial services business in California generally, and in the Company’s market areas specifically, is highly competitive. The industry continues to consolidate and unregulated competitors have entered banking markets with products targeted at highly profitable customer segments. Many larger

unregulated competitors are able to compete across geographic boundaries, and provide customers with meaningful alternatives to most significant banking services and products. These consolidation trends are likely to continue. The increasingly competitive

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environment is a result primarily of changes in regulation, changes in technology and product delivery systems, and the consolidation among financial service providers.

With respect to commercial bank competitors, the business is dominated by a relatively small number of major banks that operate a large number of offices within our geographic footprint. For the combined Alameda, Contra Costa, Marin, San Benito, San Francisco, San Mateo, and Santa Clara county region, the seven counties within which the Company operates, the top three institutions are all multi-billion dollar entities with an aggregate of 382 offices that control a combined 59.21% of deposit market share based on June 30, 2022 FDIC market share data. HBC ranks seventeenth with 0.53% share of total deposits based on June 30, 2022 market share data. Larger institutions have, among other advantages, the ability to finance wide-ranging advertising campaigns and to allocate their resources to regions of highest yield and demand. Larger banks are seeking to expand lending to small businesses, which are traditionally community bank customers. They can also offer certain services that we do not offer directly, but may offer indirectly through correspondent institutions. By virtue of their greater total capitalization, these banks also have substantially higher lending limits than we do. For customers whose needs exceed our legal lending limit, we arrange for the sale, or “participation,” of some of the balances to financial institutions that are not within our geographic footprint.

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

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

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

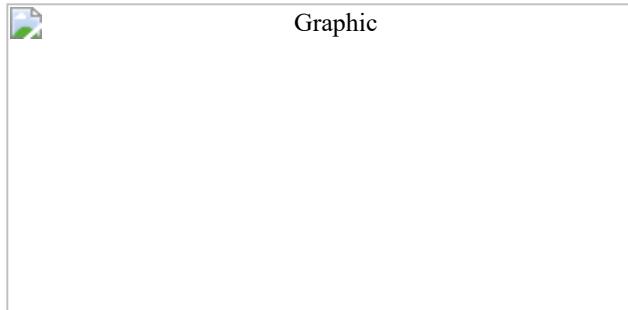
HUMAN CAPITAL

We strive to be the employer of choice in our markets where every employee has the opportunity to thrive. We deeply believe that employees fuel the success of our Company. To that end, we are fully committed to hiring, developing, promoting and retaining a workforce that shares our value of cultivating a culture of teamwork, diversity, inclusivity and accountability. The ultimate goal is to deepen client and community relationships and deliver an exceptional experience to all whom we serve.

In 2022, we had 340 full time equivalent employees (inclusive of 11 part-time employees) with an average tenure of 8 years. Our turnover rate was 19%, and of those, 24% were due to retirement, health reasons or relocation out of our service footprint. We are proud to share that females represent 63% of our workforce and self-identified racial and/or

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ethnic diverse individuals represent approximately 52%. Of all new hires in 2022 61% were females and 63% were racially and/or ethnically diverse individuals.

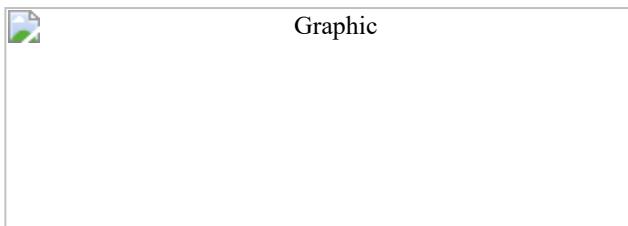


Diversity, Equity, Inclusion and Belonging

We codified our Diversity, Equity, Inclusion and Belonging (“DEIB”) Charter and established an Executive DEIB Steering Committee in 2021. In the summer of 2022, we hired an Executive Vice President and Chief People and Diversity Officer to help the Company further enhance and cultivate a culture of openness, transparency and belonging. Management has been sharing DEIB progress with the Board on a quarterly basis and will continue to do so.

The voice of the team is critical to guide the Company to further enhance employee engagement and Company culture. The Chief People and Diversity Officer along with other senior leaders hosted listening sessions offered to all employees, allowing for one-on-one meetings and group conversations. Common themes, strengths and opportunities gathered from employees were summarized and shared with the Senior Executive Operating Committee members and the DEIB Steering Committee. Two top common themes emerged: employees wanted to be more involved with impacting the Company’s culture and many desired more DEIB education.

We partnered with an external consultancy firm to develop our inaugural “Exploring Diversity, Equity, Inclusion and Belonging” in-person seminar and rolled out the seminar starting with the attendance of our CEO and the executive team in October 2022. By February 2023, 93% of Senior Vice President levels and above attended the seminar and we have a roadmap to have all active employees complete the training by mid-Q2 2023. Understanding DEIB’s impact in the workplace, historical events that underline the importance of DEIB, and exploring and interrupting our own negative unconscious biases were some of the key elements immersed in the seminar.

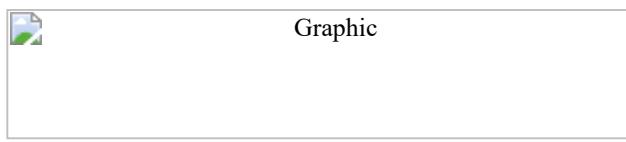
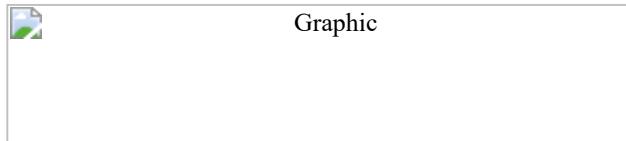


Based on feedback from listening sessions, we also created a self-nominated Culture Ambassador Group (akin to employee resource groups for larger organizations) comprised of non-executive employees from various departments and locations. Through self-identification, the Culture Ambassadors represent 73% female and 64% ethnic/racial diversity. Culture Ambassadors serve an important role to work on enterprise initiatives such as creation of corporate values, promoting awareness of various cultures, as well as provide timely and ongoing feedback to the DEIB Steering Committee. They are an important part of our communication vehicle to enhance DEIB initiatives and serve as the go-to person in each market keeping abreast of team sentiments.

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Sustainability and Corporate Social Responsibility

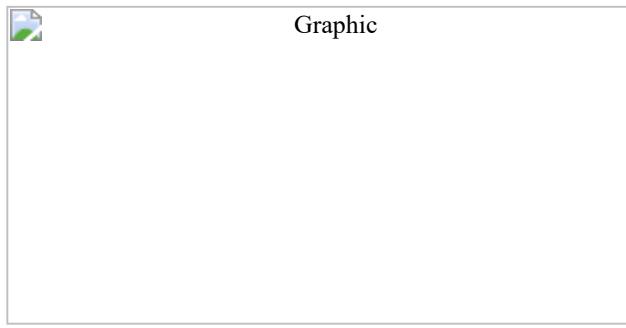
We relaunched our Heritage Hearts Committee with a mission to source non-profit volunteer and board opportunities for Bank employees across the Bay Area. In 2022, we contributed over 2,000 hours to strengthening our relationship with local nonprofit organizations and more than 45 employees serve on nonprofit boards. Our broad outreach efforts cover a variety of focus areas like economic development, education, health and human services, housing and homelessness, small business support, animal services, environmental, and arts and culture.



We continued to expand on existing communication efforts such as our anonymous “Ask CEO” portal with our CEO, Clay Jones, providing answers and updates during regularly scheduled all-hands meetings. We also encourage employees to submit suggestions through our “Big Idea” electronic portal. Additionally, several executives host cross-functional focus groups throughout the year to gain better perspectives of what we do well and where we can do better.

Talent Development and Succession Planning

Our Company’s pay for performance compensation philosophy offers all employees the opportunity to earn annual bonuses in addition to base salaries depending on individual and team performance results. We adhere to the new Senate Bill 1162 CA Pay Transparency Regulations on requirements and the spirit behind the bill. We use a balanced performance evaluation approach to assess four core areas: Business Results, Internal/External Client Experience, Teamwork/Leadership and Risk/Compliance/Controls.



Throughout the year, employees have the opportunity to participate in a variety of learning and education programs such as attending internal and external seminars/workshops, on-line training courses, panel discussions and trade group conferences to enrich one’s own development. Additionally, we offer a generous tuition reimbursement to support employees’ desire in pursuing higher education degrees. Employees also have the opportunity to earn industry related and/or role related professional certifications and our Company reimburses for classes, materials, test fees, and ongoing required education costs. Each year, we also offer leaders to attend Pacific Coast Banking School as part of their career development plan.

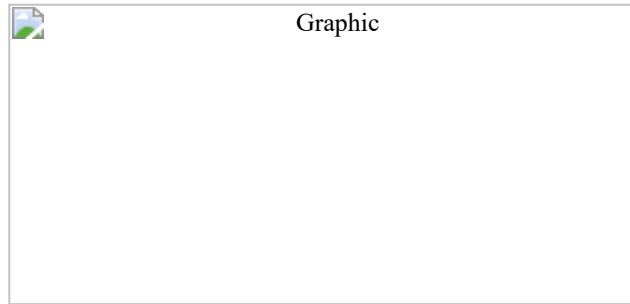
We further enhanced our Talent Management and Succession Planning framework that was shared with the Board of Directors which includes ongoing Board governance oversight for CEO and executive officers. We developed a robust Succession Planning roadmap that clearly outlines a plan for unexpected

vacancies and a longer term executive talent development plan for executive ranks and key roles. Additionally, we've embedded a discipline of building a strong

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external diverse talent pipeline for executive and board seats. The enhanced Succession Planning framework will continue to evolve and will cascade to the non-executive population starting in 2023.

Internal career mobility continues to be an important part of employee engagement and development. In 2022, 62% of promotions were females and 58% were racial or ethnically diverse. Additionally, females accounted for 71% of internal transfers and racially or ethnically diverse accounted for 47%.



Culture and Conduct

Teamwork is not only promoted but celebrated through various recognition programs. One of our most popular programs allow managers to award physical tokens called “FOCUS” (friendly, outstanding, courteous, unequaled, and service) to individuals to thank them for going above and beyond their responsibilities. At year end, employees exchange their physical tokens for currency. In 2022, 119 employees received token awards. Additionally, we also celebrate anniversary milestones allowing employees to select a gift of their choosing.

We pride ourselves for expecting and enforcing nothing less than the highest level of integrity, ethical standards, operational excellence and will always strive do what's right. We continually promote a speak-up culture so our workplace feels welcoming and safe. We expect employees to treat, clients and stakeholders with common courtesy and respect at all times. We take all complaints seriously and promptly investigate concerns. Employees have the ability to report concerns through a variety of channels including their immediate manager, any leader at the company, Human Resources or through our external anonymous complaints hotline. We have a zero tolerance, non-retaliation policy.

Health and Safety

Our employees are our most valuable resource, and their safety, health, and wellbeing is of paramount to our Company's success. We support the wellness of all colleagues through various programs, including Employee Assistance Program “EAP”, health seminars, education programs and health club memberships. All employees are eligible to take advantage of our EAP programs which offer counseling services, family support, help on financial and legal issues, and mental health support.

We continue to closely monitor the impacts of COVID-19 as the safety of our clients and employees continues to become of paramount priority. We will continue to follow and adhere to COVID-19 safety protocol recommendations from local health officials, Center for Disease Control (“CDC”) and Occupational Safety and Health Act (“OSHA”) agencies.

Supervision and Regulation

General

Financial institutions, their holding companies and their affiliates are extensively regulated under U.S. federal and state law. As a result, the growth and earnings performance of the Company and its subsidiaries may be affected not only by management decisions and general economic conditions, but also by the requirements of federal and state statutes and by the regulations and policies of various bank regulatory

agencies, including the California Department of Financial Protection and Innovation (“DFPI”), the Federal Reserve, the FDIC, and the Consumer Financial Protection Bureau

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(“CFPB”). Furthermore, tax laws administered by the Internal Revenue Service and state taxing authorities, accounting rules developed by the Financial Accounting Standards Board (“FASB”), securities laws administered by the SEC and state securities authorities, and anti-money laundering laws enforced by the Treasury have an impact on our business. These statutes, regulations, regulatory policies and rules are significant to the financial condition and results of operations of the Company and its subsidiaries, including HBC. The nature and extent of future legislative, regulatory or other changes affecting financial institutions are impossible to predict with any certainty.

Federal and state banking laws impose a comprehensive system of supervision, regulation and enforcement on the operations of financial institutions, their holding companies and affiliates intended primarily for the protection of the FDIC-insured deposits and depositors of banks, rather than their shareholders. These federal and state laws, and the related regulations of the bank regulatory agencies, affect, among other things, the scope of business, the kinds and amounts of investments banks and bank holding companies may make, their reserve requirements, capital levels relative to operations, the nature and amount of collateral for loans, the establishment of branches, the ability to merge, consolidate and acquire, dealings with insiders and affiliates and the payment of dividends.

This supervisory and regulatory framework subjects banks and bank holding companies to regular examination by their respective regulatory agencies, which results in examination reports and ratings that, while not publicly available, can affect the conduct and growth of their businesses. These examinations consider not only compliance with applicable laws and regulations, but also capital levels, asset quality and risk, management ability and performance, earnings, liquidity, and various other factors. The regulatory agencies generally have broad discretion to impose restrictions and limitations on the operations of a regulated entity where the agencies determine, among other things, that such operations are unsafe or unsound, fail to comply with applicable law or are otherwise inconsistent with laws and regulations or with the supervisory policies of these agencies.

The following is a summary of the material elements of the supervisory and regulatory framework applicable to the Company and its subsidiaries, including HBC. It does not describe all of the statutes, regulations and regulatory policies that apply, nor does it restate all of the requirements of those that are described. The descriptions are qualified in their entirety by reference to the particular statutory and regulatory provision.

Financial Regulatory Reform

Legislation and regulations enacted and implemented since 2008 in response to the U.S. economic downturn and financial industry instability continue to impact most institutions in the banking sector. Many of the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”), which was enacted in 2010, have affected our operations and expenses, including but not limited to changes in FDIC assessments, the permitted payment of interest on demand deposits, and enhanced compliance requirements. Some of the Dodd-Frank rules and regulations will apply directly only to institutions much larger than ours, but could indirectly impact smaller banks, either due to competitive influences or because certain practices required for larger institutions may subsequently become expected “best practices” for smaller institutions. We could see continued attention and resources devoted by the Company to ensure compliance with the statutory and regulatory requirements engendered by Dodd-Frank.

Regulatory Capital Requirements

The Company and HBC are subject to a comprehensive capital framework (the “Capital Rules”) adopted by Federal banking regulators (including the Federal Reserve and the FDIC). The Capital Rules implement the Basel III framework for strengthening the regulation, supervision and risk management of banks, as well as certain provisions of Dodd-Frank. The Capital Rules generally recognize three components, or tiers, of capital: common equity Tier 1 capital, additional Tier 1 capital and Tier 2 capital. Common equity Tier 1 capital generally consists of retained earnings and common stock instruments (subject to certain adjustments), as well as accumulated other comprehensive income (“AOCI”) except to the extent that the Company and HBC exercise a one-time irrevocable option to exclude certain components of AOCI. Both the

Company and HBC made this election in 2015. Additional Tier 1 capital generally includes non-cumulative preferred stock and related surplus subject to certain adjustments and limitations. Tier 2 capital generally includes certain capital instruments (such as subordinated debt) and portions of the amounts of the allowance for credit losses, subject to certain requirements and deductions. The term “Tier 1 capital” means common equity Tier 1 capital plus additional Tier 1 capital, and the term “total capital” means Tier 1 capital plus Tier 2 capital.

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The Capital Rules generally measure an institution's capital using four capital measures or ratios. The common equity Tier 1 capital ratio is the ratio of the institution's common equity Tier 1 capital to its total risk-weighted assets. The Tier 1 risk-based capital ratio is the ratio of the institution's Tier 1 capital to its total risk-weighted assets. The total risk-based capital ratio is the ratio of the institution's total capital to its total risk-weighted assets. The Tier 1 leverage ratio is the ratio of the institution's Tier 1 capital to its average total consolidated assets. To determine risk-weighted assets, assets of an institution are generally placed into a risk category as prescribed by the regulations and given a percentage weight based on the relative risk of that category. An asset's risk-weighted value will generally be its percentage weight multiplied by the asset's value as determined under generally accepted accounting principles. In addition, certain off-balance-sheet items are converted to balance-sheet credit equivalent amounts, and each amount is then assigned to one of the risk categories. An institution's federal regulator may require the institution to hold more capital than would otherwise be required under the Capital Rules if the regulator determines that the institution's capital requirements under the Capital Rules are not commensurate with the institution's credit, market, operational or other risks.

To be adequately capitalized, both the Company and HBC are required to have a common equity Tier 1 capital ratio of at least 4.5% or more, a Tier 1 leverage ratio of 4.0% or more, a Tier 1 risk-based ratio of 6.0% or more and a total risk-based ratio of 8.0% or more. In addition to the preceding requirements, both the Company and HBC are required to maintain a "conservation buffer" consisting of common equity Tier 1 capital, which is at least 2.5% above each of the required minimum levels. An institution that does not meet the conservation buffer will be subject to restrictions on certain activities including payment of dividends, stock repurchases and discretionary bonuses to executive officers.

The Capital Rules set forth the manner in which certain capital elements are determined, including but not limited to, requiring certain deductions related to mortgage servicing rights and deferred tax assets.

The Capital Rules also prescribe the methods for calculating certain risk-based assets and risk-based ratios. Higher or more sensitive risk weights are assigned to various categories of assets, among which are credit facilities that finance the acquisition, development or construction of real property, certain exposures or credits that are 90 days past due or are nonaccrual, foreign exposures, certain corporate exposures, securitization exposures, equity exposures and in certain cases mortgage servicing rights and deferred tax assets.

Heritage Commerce Corp

General. As a bank holding company, HCC is subject to regulation, supervision and periodic examination by the Federal Reserve under the Bank Holding Company Act of 1956, as amended (the "BHCA"). HCC is required to file with the Federal Reserve periodic reports of its operations and such additional information as the Federal Reserve may require. In accordance with Federal Reserve laws and regulations, HCC is required to act as a source of financial strength to HBC and to commit resources to support HBC in circumstances where HCC might not otherwise do so.

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

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

The Sarbanes Oxley Act of 2002. HCC is subject to the accounting oversight and corporate governance requirements of the Sarbanes Oxley Act of 2002, as amended (the “Sarbanes-Oxley Act”). These include, among others: (i) required executive certification of financial presentations; (ii) increased requirements for board audit committees and their members; (iii) enhanced disclosure of controls and procedures and internal control over financial reporting; (iv)

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enhanced controls over and reporting of insider trading; and (v) increased penalties for financial crimes and forfeiture of executive bonuses in certain circumstances.

Permitted Activities. The BHCA generally prohibits HCC from acquiring direct or indirect ownership or control of more than 5% of the voting shares of any company that is not a bank and from engaging in any business other than that of banking, managing and controlling banks or furnishing services to banks and their subsidiaries. This general prohibition is subject to a number of exceptions. The principal exception allows bank holding companies to engage in, and to own shares of companies engaged in, certain businesses found by the Federal Reserve prior to November 11, 1999 to be “so closely related to banking as to be a proper incident thereto.” This authority would permit HCC to engage in a variety of banking-related businesses, including the ownership and operation of a savings association, or any entity engaged in consumer finance, equipment leasing, the operation of a computer service bureau (including software development) and mortgage banking and brokerage. The BHCA generally does not place territorial restrictions on the domestic activities of nonbank subsidiaries of bank holding companies. The Federal Reserve has the power to order any bank holding company or its subsidiaries to terminate any activity or to terminate its ownership or control of any subsidiary when the Federal Reserve has reasonable grounds to believe that continuing such activity, ownership or control constitutes a serious risk to the financial soundness, safety or stability of any bank subsidiary of the bank holding company.

Bank holding companies that meet certain qualifications and elect to be treated as financial holding companies may engage in, and affiliate with financial companies engaging in, a broader range of activities than would otherwise be permitted for a bank holding company, including activities that the Federal Reserve deems to be financial in nature or incidental or complementary to activities that are financial in nature. “Financial in nature” activities include securities underwriting, dealing and market making; sponsoring mutual funds and investment companies; insurance underwriting and sales; merchant banking; and other activities that the Federal Reserve, in consultation with the Secretary of the Treasury, determines to be financial in nature or incidental to such financial activity. “Complementary activities” are activities that the Federal Reserve determines upon application to be complementary to a financial activity and that do not pose a safety and soundness risk. HCC has not elected to be a financial holding company, and we have not engaged in any activities determined by the Federal Reserve to be financial in nature or incidental or complementary to activities that are financial in nature.

Capital Requirements. Bank holding companies are required to maintain capital in accordance with Federal Reserve capital adequacy requirements, as affected by Dodd-Frank and Basel III. For a discussion of capital requirements, see “Regulatory Capital Requirements” above.

Source of Strength Doctrine. Federal Reserve policy historically required bank holding companies to act as a source of financial and managerial strength to their subsidiary banks. Dodd-Frank codified this policy as a statutory requirement. HCC is required to act as a source of strength to HBC and to commit capital and financial resources to support HBC, including at times when HCC may not be in a financial position to do so. HCC must stand ready to use its available resources to provide adequate capital to HBC during periods of financial stress or adversity. HCC must also maintain the financial flexibility and capital raising capacity to obtain additional resources for assisting HBC. HCC’s failure to meet its source of strength obligations may constitute an unsafe and unsound practice, a violation of the Federal Reserve’s regulations, or both. The source of strength doctrine most directly affects bank holding companies whose subsidiary bank fails to maintain adequate capital levels. In such situation, the subsidiary bank will be required by the bank’s federal regulator to take “prompt corrective action.” Any capital loans by a bank holding company to its subsidiary bank are subordinate in right of payment to deposits and to certain other indebtedness of the bank. In the event of a bank holding company’s bankruptcy, its commitment to a federal bank regulatory agency to maintain the capital of its subsidiary bank will be assumed by the bankrupt trustee and entitled to priority of payment.

Dividend Payments, Stock Redemptions and Repurchases. HCC’s ability to pay dividends to its shareholders is affected by both general corporate law considerations and the policies of the Federal Reserve applicable to bank holding companies. As a general matter, the Federal Reserve has indicated that the board of directors of a bank holding company should eliminate, defer or significantly reduce dividends to shareholders if: (i) the bank holding company’s net income available to shareholders for the past four quarters, net of

dividends previously paid during that period, is not sufficient to fully fund the dividends; (ii) the prospective rate of earnings retention is inconsistent with the bank holding company's capital needs and overall current and prospective financial condition; or (iii) the bank holding company will not meet, or is in danger of not meeting, its minimum regulatory capital adequacy ratios. Failure to adhere to these policies could cause

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the Federal Reserve to prohibit or limit the payment of dividends by the banking organization because doing so would constitute an unsafe or unsound practice in light of the financial condition of the banking organization. In addition, under the Capital Rules, institutions that seek to pay dividends must maintain 2.5% in common equity Tier 1 capital attributable to the capital conservation buffer. See “Supervision and Regulation—Regulatory Capital Requirements.”

Subject to exceptions for well-capitalized and well-managed bank holding companies, Federal Reserve regulations also require approval of bank holding company purchases and redemptions of its securities if the gross consideration paid exceeds 10 percent of consolidated net worth for any 12-month period. In addition, under Federal Reserve policies, bank holding companies must consult with and inform the Federal Reserve in advance of (i) redeeming or repurchasing capital instruments when experiencing financial weakness and (ii) redeeming or repurchasing common stock and perpetual preferred stock if the result will be a net reduction in the amount of such capital instruments outstanding for the quarter in which the reduction occurs.

As a California corporation, HCC is subject to the limitations of California law, which allows a corporation to distribute cash or property to shareholders, including a dividend or repurchase or redemption of shares, if the corporation meets either a “retained earnings” test or a “balance sheet” test. Under the “retained earnings” test, HCC may make a distribution from retained earnings to the extent that its retained earnings exceed the sum of (i) the amount of the distribution plus (ii) the amount, if any, of dividends in arrears on shares with preferential dividend rights. HCC may also make a distribution under the “balance sheet” test if, immediately after the distribution, the value of its assets equals or exceeds the sum of (i) its total liabilities plus (ii) the liquidation preference of any shares which have a preference upon dissolution over the rights of shareholders receiving the distribution. Indebtedness is not considered a liability if the terms of such indebtedness provide that payment of principal and interest thereon are to be made only if, and to the extent that, a distribution to shareholders could be made under the balance sheet test. In addition, HCC may not make distributions if it is, or as a result of the distribution would be, likely to be unable to meet its liabilities (except those whose payment is otherwise adequately provided for) as they mature. A California corporation may specify in its articles of incorporation that distributions under the retained earnings test or balance sheet test can be made without regard to the preferential rights amount. HCC’s articles of incorporation do not address distributions under either the retained earnings test or the balance sheet test.

Acquisitions, Activities and Change in Control. The BHCA generally requires the prior approval by the Federal Reserve for any merger involving a bank holding company, any bank holding company’s acquisition of more than 5% of a class of voting securities of an unaffiliated bank or bank holding company, or acquisition of all or substantially all of the assets of a bank or bank holding company. In reviewing applications seeking approval of merger and acquisition transactions, the Federal Reserve considers, among other things, the competitive effect and public benefits of the transactions, the capital position and managerial resources of the combined organization, the risks to the stability of the U.S. banking or financial system, the convenience and needs of the communities to be served, including the applicant’s performance record under the Community Reinvestment Act of 1977, as amended (the “CRA”), compliance with fair housing and other consumer protection laws, and the effectiveness in combating money laundering activities. In addition, failure to implement or maintain adequate compliance programs could cause bank regulators not to approve an acquisition where regulatory approval is required or to prohibit an acquisition even if approval is not required.

Subject to certain conditions (including deposit concentration limits established by the BHCA and Dodd-Frank), the Federal Reserve may allow a bank holding company to acquire banks located in any state of the United States. In approving interstate acquisitions, the Federal Reserve is required to give effect to applicable state law limitations on the aggregate amount of deposits that may be held by the acquiring bank holding company and its insured depository institution affiliates in the state in which the target bank is located (provided that those limits do not discriminate against out-of-state depository institutions or their holding companies) and state laws that require that the target bank have been in existence for a minimum period of time (not to exceed five years) before being acquired by an out-of-state bank holding company. Furthermore, in accordance with Dodd-Frank, bank holding companies must be well-capitalized and well-managed in order to complete interstate mergers or acquisitions. For a discussion of the capital requirements, see “—Regulatory Capital Requirements” above. The FDIC and the U.S. Department of Justice’s Antitrust Division recently

sought public comment on their bank merger review guidelines, which suggests that the analytical framework that has guided the regulatory review of bank mergers or the manner in which the regulatory standards apply may change.

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Federal law also prohibits any person or company from acquiring control of an FDIC-insured depository institution or its holding company without prior notice to the appropriate federal bank regulator.

The Federal Reserve applies a tiered framework of presumptions for determining control of a banking organization under the BHCA, where the level of voting share ownership is assessed in combination with relationship-based factors to determine whether control exists. “Control” is conclusively presumed to exist upon the acquisition of 25% or more of the outstanding voting securities of a bank or bank holding company, but may arise under certain circumstances between 5% and 24.99% ownership.

Under the California Financial Code, any proposed acquisition of control of HBC must be approved by the Commissioner of the DFPI. The California Financial Code defines “control” as the power, directly or indirectly, to direct HBC’s management or policies or to vote 25% or more of any class of HBC’s outstanding voting securities. Additionally, a rebuttable presumption of control arises when any person (including a company) seeks to acquire, directly or indirectly, 10% or more of any class of HBC’s outstanding voting securities.

Heritage Bank of Commerce

General. HBC is a California state-chartered commercial bank that is a member of the Federal Reserve System and whose deposits are insured by the FDIC. HBC is subject to regulation, supervision, and regular examination by the DFPI and the Federal Reserve as HBC’s primary federal regulator. The regulations of these agencies govern most aspects of a bank’s business.

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

HBC is a member of the FHLB of San Francisco. Among other benefits, each FHLB serves as a reserve or central bank for its members within its assigned region and makes available loans or advances to its members. Each FHLB is financed primarily from the sale of consolidated obligations of the FHLB system. As an FHLB member, HBC is required to own a certain amount of capital stock in the FHLB. As of December 31, 2022, HBC was in compliance with the FHLB’s stock ownership requirement. FHLB stock is carried at cost and classified as a restricted security. Both cash and stock dividends are reported as income.

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

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

Brokered Deposit Restrictions. Well capitalized institutions are not subject to limitations on brokered deposits, while an adequately capitalized institution is able to accept, renew or roll over brokered deposits only with a waiver from the FDIC and subject to certain restrictions on the yield paid on such deposits. Undercapitalized institutions are generally not permitted to accept, renew, or roll over brokered deposits. As of December 31, 2022, HBC was eligible to accept brokered deposits without limitations.

Loans to One Borrower. With certain limited exceptions, the maximum amount that a California bank may lend to any borrower at any one time (including the obligations to the bank of certain related entities of the borrower) may not exceed 25% (and unsecured loans may not exceed 15%) of the bank's shareholders' equity, allowance for credit losses on loans, and any capital notes and debentures of the bank.

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

Deposit Insurance. HBC is a member of the Deposit Insurance Fund (“DIF”) administered by the FDIC, which insures customer deposit accounts. The amount of federal deposit insurance coverage is \$250,000 per depositor, for each account ownership category at each depository institution. The \$250,000 amount is subject to periodic adjustments. In order to maintain the DIF, member institutions are assessed insurance premiums based on an insured institution’s average consolidated total assets less its average tangible equity capital.

Each institution is provided an assessment rate, which is generally based on the risk that the institution presents to the DIF. Institutions with less than \$10 billion in assets generally have an assessment rate that can range from 1.5 to 30 basis points. However, the FDIC has flexibility to adopt assessment rates without additional rule-making provided that the total base assessment rate increase or decrease does not exceed 2 basis points. In October 2022, the FDIC adopted a final rule to increase initial base deposit insurance assessment rate schedules uniformly by 2 basis points, beginning in the first quarterly assessment period of 2023.

Supervisory Assessments. California-chartered banks are required to pay supervisory assessments to the DFPI to fund its operations. The amount of the assessment paid by a California bank to the DFPI is calculated on the basis of the institution’s total assets, including consolidated subsidiaries, as reported to the DFPI. During the year ended December 31, 2022, HBC paid supervisory assessments to the DFPI totaling \$324,000.

Capital Requirements. Banks are generally required to maintain capital levels in excess of other businesses. For a discussion of capital requirements, see “—Regulatory Capital Requirements.”

Prompt Corrective Action Regulations. The FDIA establishes a framework for regulation of insured depository institutions by federal banking regulators. As part of that framework, federal banking regulators are required to take “prompt corrective action” with respect to any FDIC-insured depository institutions that do not meet certain capital adequacy standards. Supervisory actions under the “prompt corrective action” rules generally depend upon an institution’s classification within five capital categories, under which a bank is classified as:

- “well capitalized” if it has a total risk-based capital ratio of 10.0% or more, a Tier 1 risk-based capital ratio of 8.0% or more, a common equity Tier 1 risk-based ratio of 6.5% or more, and a leverage capital ratio of 5.0% or more, and is not subject to any written agreement, order or capital directive to meet and maintain a specific capital level for any capital measure;
- “adequately capitalized” if it has a total risk-based capital ratio of 8.0% or more, a Tier 1 risk-based capital ratio of 6.0% or more, a common equity Tier 1 risk-based ratio of 4.5% or more, and a leverage capital ratio of 4.0% or more;
- “undercapitalized” if it has a total risk-based capital ratio less than 8.0%, a Tier 1 risk-based capital ratio less than 6.0%, a common equity risk-based ratio less than 4.5% or a leverage capital ratio less than 4.0%;
- “significantly undercapitalized” if it has a total risk-based capital ratio less than 6.0%, a Tier 1 risk-based capital ratio less than 4.0%, a common equity risk-based ratio less than 3.0% or a leverage capital ratio less than 3.0%; or

- “critically undercapitalized” if it has a ratio of tangible equity to total assets that is equal to or less than 2.0%.

A bank that, based upon its capital levels, is classified as “well capitalized,” “adequately capitalized” or “undercapitalized” may be treated as though it were in the next lower capital category if the appropriate federal banking

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agency, after notice and opportunity for a hearing, determines that an unsafe or unsound condition, or an unsafe or unsound practice, warrants such treatment.

An institution that fails to remain well-capitalized becomes subject to a series of restrictions that increase in severity as its capital condition weakens. At each successive lower capital category, an insured bank is subject to increasingly severe supervisory actions. These actions include, but are not limited to, restrictions on asset growth, interest rates paid on deposits, branching, allowable transactions with affiliates, ability to pay bonuses and raises to senior executives and pursuing new lines of business. Additionally, all “undercapitalized” banks are required to implement capital restoration plans to restore capital to at least the “adequately capitalized” level, and the FDIC is generally required to close “critically undercapitalized” banks within a 90-day period. HBC meets the definition of a “well capitalized” institution.

Dividend Payments. The primary source of funds for HCC is dividends from HBC. Under the California Financial Code, HBC is permitted to pay a dividend in the following circumstances: (i) without the consent of either the DFPI or HBC’s shareholders, in an amount not exceeding the lesser of (a) the retained earnings of HBC; or (b) the net income of HBC for its last three fiscal years, less the amount of any distributions made during the prior period; (ii) with the prior approval of the DFPI, in an amount not exceeding the greatest of: (a) the retained earnings of HBC; (b) the net income of HBC for its last fiscal year; or (c) the net income for HBC for its current fiscal year; and (iii) with the prior approval of the DFPI and HBC’s shareholders (i.e., HCC) in connection with a reduction of its contributed capital.

The payment of dividends by any financial institution is affected by the requirement to maintain adequate capital pursuant to applicable capital adequacy guidelines and regulations, and a financial institution generally is prohibited from paying any dividends if, following payment thereof, the institution would be undercapitalized. In addition, in order to pay a dividend, the Capital Rules generally require that a financial institution must maintain over a 2.5% in common equity tier 1 capital attributable to the Capital Conservation Buffer. See “—Regulatory Capital Requirements.” As described above, HBC exceeded its minimum capital requirements under applicable regulatory guidelines as of December 31, 2022.

Transactions with Affiliates. Transactions between depository institutions and their affiliates, including transactions between HBC and HCC, are governed by Sections 23A and 23B of the Federal Reserve Act and the Federal Reserve’s Regulation W. Generally, Section 23A limits the extent to which a depository institution and its subsidiaries may engage in “covered transactions” with any one affiliate to an amount equal to 10% of the depository institution’s capital stock and surplus. It further limits transactions with all affiliates in the aggregate to an amount equal to 20% of the depository institution’s capital stock and surplus. Section 23A also establishes specific collateral requirements for loans or extensions of credit to, or guarantees, acceptances or letters of credit issued on behalf of, an affiliate. Section 23B requires that covered transactions and a broad list of other specified transactions be on terms substantially the same, or at least as favorable to the depository institution and its subsidiaries, as those for similar transactions with non-affiliates.

Loans to Directors, Executive Officers and Principal Shareholders. The authority of HBC to extend credit to its directors, executive officers and principal shareholders, including their immediate family members and corporations and other entities that they control, is subject to substantial restrictions and requirements under the Federal Reserve’s Regulation O, as well as the Sarbanes-Oxley Act. These laws and regulations impose limits on the amount of loans HBC may make to directors and other insiders. A violation of these restrictions may result in the assessment of substantial civil monetary penalties on the affected bank or any officer, director, employee, agent or other person participating in the conduct of the affairs of that bank, the imposition of a cease and desist order, and other regulatory sanctions.

Standards for Safety and Soundness. The federal banking regulatory agencies adopted regulations that set forth guidelines for all insured depository institutions prescribing safety and soundness standards. These guidelines establish general standards for internal controls, information systems, internal audit systems, loan documentation, credit underwriting, interest rate risk exposure, asset growth, asset quality, earnings standards, compensation, fees and benefits. In general, the guidelines require appropriate systems and practices to identify and manage the risks and exposures specified in the guidelines before capital becomes impaired. The guidelines prohibit excessive compensation as an unsafe and unsound practice and describe

compensation as excessive when the amounts paid are unreasonable or disproportionate to the services performed by an executive officer, employee, director, or principal shareholder.

Each insured depository institution must implement a comprehensive written information security program that includes administrative, technical and physical safeguards appropriate to the institution's size and complexity and the

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nature and scope of its activities. The information security program also must be designed to ensure the security and confidentiality of customer information, protect against any unanticipated threats or hazards to the security or integrity of such information, protect against unauthorized access to or use of such information that could result in substantial harm or inconvenience to any customer and ensure the proper disposal of customer and consumer information. Each insured depository institution must also develop and implement a risk-based response program to address incidents of unauthorized access to customer information in customer information systems. If the FDIC determines that HBC fails to meet any standard prescribed by the guidelines, it may be required to submit an acceptable plan to achieve compliance with the standard.

Risk Management. Bank regulatory agencies have increasingly emphasized the importance of sound risk management processes and strong internal controls when evaluating the activities of the financial institutions they supervise. Properly managing risks has been identified as critical to the conduct of safe and sound banking activities and has become even more important as new technologies, product innovation, and the size and speed of financial transactions have changed the nature of banking markets. The agencies have identified a spectrum of risks facing a banking institution including, but not limited to, credit, market, liquidity, operational, legal, and reputational risk. In particular, recent regulatory pronouncements have focused on operational risk, which arises from the potential that inadequate information systems, operational problems, breaches in internal controls, fraud, or unforeseen catastrophes will result in unexpected losses. New products and services, third-party risk management and cybersecurity are critical sources of operational risk that financial institutions are expected to address in the current environment. HBC is expected to have active board and senior management oversight; adequate policies, procedures, and limits; adequate risk measurement, monitoring, and management information systems; and comprehensive internal controls.

Branching Authority. California banks, such as HBC, may, under California law, establish a banking office so long as the bank's board of directors approves the banking office and the DFPI is notified of the establishment of the banking office. Deposit-taking banking offices must be approved by the FDIC, which considers a number of factors, including financial history, capital adequacy, earnings prospects, character of management, needs of the community and consistency with corporate power. Dodd-Frank permits insured state banks to engage in de novo interstate branching if the laws of the state where the new banking office is to be established would permit the establishment of the banking office if it were chartered by such state. Finally, we may also establish banking offices in other states by merging with banks or by purchasing banking offices of other banks in other states, subject to certain regulatory restrictions.

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

The federal banking agencies have adopted regulations which measure a bank's compliance with its CRA obligations on a performance based evaluation system. The current system bases CRA ratings on an institution's actual lending service and investment performance rather than the extent to which the institution conducts needs assessments, documents community outreach or complies with other procedural requirements. The ratings range from "outstanding" to a low of "substantial noncompliance." HBC had a CRA rating of "satisfactory" as of its most recent regulatory examination. In May 2022, the Federal Reserve, along with the FDIC and the OCC, issued proposed amendments to modernize the CRA regulatory framework, partly to address changes that have occurred due to the rise in digital banking. Some of the key proposed revisions include clarification of eligible community development activities, adjustments to requirements and eligibility of activities outside of facility-based assessment areas, and new testing structures and data collection requirements, particularly for the largest banks.

Anti-Money Laundering and Office of Foreign Assets Control Regulation. We are subject to federal laws aiming to counter money laundering and terrorist financing, as well as transactions with persons,

companies and foreign governments sanctioned by the United States. These laws include the PATRIOT Act, the Bank Secrecy Act (“BSA”), and the Anti-Money Laundering Act (“AMLA”), among others. The PATRIOT Act is designed to deny terrorists and criminals the ability to obtain access to the U.S. financial system and has significant implications for depository institutions, brokers,

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dealers and other businesses involved in the transfer of money. The PATRIOT Act mandates financial services companies to have policies and procedures with respect to measures designed to address any or all of the following matters: (i) customer identification programs; (ii) money laundering; (iii) terrorist financing; (iv) identifying and reporting suspicious activities and currency transactions; (v) currency crimes; and (vi) cooperation between financial institutions and law enforcement authorities. Regulatory authorities routinely examine financial institutions for compliance with these obligations, and failure of a financial institution to maintain and implement adequate programs to combat money laundering and terrorist financing, or to comply with all of the relevant laws or regulations, could have serious legal and reputational consequences for the institution, including causing applicable bank regulatory authorities not to approve merger or acquisition transactions when regulatory approval is required or to prohibit such transactions even if approval is not required. Regulatory authorities have imposed cease and desist orders and civil money penalties against institutions found to be violating these obligations.

In January 2021, a comprehensive reform and modernization to U.S. bank secrecy and anti-money laundering laws was adopted, part of which was the adoption of AMLA. Among other things, it codified a risk-based approach to anti-money laundering compliance for financial institutions. AMLA requires financial institutions to develop standards for evaluating technology and internal processes for BSA compliance, expands enforcement-related and investigation-related authority, institutes BSA whistleblower initiatives and protections, and increases sanctions for certain BSA violations. Adopted as part of the 2021 revisions of the anti-money laundering laws, the Corporate Transparency Act (the “CTA”) requires the creation of a national registry of beneficial ownership information. When the final CTA rules go into effect in 2024, they may impact the AMLA/BSA procedures and reporting requirements of financial institutions. HBC has established policies and procedures that it believes comply with these requirements.

Treasury’s Office of Foreign Assets Control (“OFAC”), administers and enforces economic and trade sanctions against targeted foreign countries and regimes under authority of various laws, including designated foreign countries, nationals and others. OFAC publishes lists of specially designated targets and countries. Financial institutions are responsible for, among other things, blocking accounts of and transactions with such targets and countries, prohibiting unlicensed trade and financial transactions with them and reporting blocked transactions after their occurrence. Banking regulators examine banks for compliance with the economic sanctions regulations administered by OFAC. Failure of a financial institution to maintain and implement adequate OFAC programs, or to comply with all of the relevant laws or regulations, could have serious legal and reputational consequences for the institution.

Concentrations in Commercial Real Estate. Concentration risk exists when a financial institution deploys too many assets to a specific industry or segment of the economy with the potential to produce losses large enough to threaten the financial institution’s health. Concentration stemming from commercial real estate (“CRE”) is one area of regulatory concern. Regulatory guidance provides supervisory criteria, including the following numerical indicators, to assist bank examiners in identifying banks with potentially significant CRE loan concentrations that may warrant greater supervisory scrutiny: (i) CRE loans exceeding 300% of capital and increasing 50% or more in the preceding three years; or (ii) construction and land development loans exceeding 100% of capital. The guidance does not limit banks’ levels of CRE lending activities, but rather guides institutions in developing risk management practices and levels of capital that are commensurate with the level and nature of their CRE concentrations. As of December 31, 2022, using regulatory definitions in the CRE Concentration Guidance, our CRE loans represented 295% of HBC total risk-based capital, as compared to 284% as of December 31, 2021. If the regulatory agencies become concerned about our CRE loan concentrations, it could limit our ability to grow by restricting approvals for the establishment or acquisition of branches, or approvals of mergers or other acquisition opportunities.

Consumer Financial Services. We are subject to a number of federal and state consumer protection laws that extensively govern our relationship with our customers. These laws include, among others, the Equal Credit Opportunity Act, the Fair Credit Reporting Act, the Truth in Lending Act, the Truth in Savings Act, the Electronic Fund Transfer Act, the Expedited Funds Availability Act, the Home Mortgage Disclosure Act, the Fair Housing Act, the Real Estate Settlement Procedures Act, the Fair Debt Collection Practices Act, the Service Members Civil Relief Act, the Military Lending Act, and these laws’ respective state law counterparts, as well as state usury laws and laws regarding unfair, deceptive or abusive acts and practices (“UDAAP”). The

consumer protection laws applicable to us, among other things, require disclosures of the cost of credit and terms of deposit accounts, provide substantive consumer rights, prohibit discrimination in credit transactions, regulate the use of credit report information, provide financial privacy protections,

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prohibit UDAAP practices, restrict our ability to raise interest rates and subject us to substantial regulatory oversight. Many states and local jurisdictions have consumer protection laws analogous to those listed above.

Violations of applicable consumer protection laws can result in significant potential liability from litigation brought by customers, including actual and statutory damages, restitution and attorneys' fees. Federal bank regulators, state attorneys general, and state and local consumer protection agencies may also seek to enforce consumer protection requirements and obtain these and other remedies, including regulatory sanctions, customer rescission rights, and civil money penalties. Non-compliance with consumer protection requirements may also result in our failure to obtain any required bank regulatory approval for merger or acquisition transactions we may wish to pursue or prohibition from engaging in such transactions even if approval is not required.

The consumer protection provisions of Dodd-Frank and the examination, supervision and enforcement of those laws and implementing regulations by the CFPB have created a more intense and complex environment for consumer finance regulation. The CFPB has significant authority to implement and enforce federal consumer protection laws and new requirements for financial services products provided for in Dodd-Frank, as well as the authority to identify and prohibit unfair, deceptive or abusive acts and practices. The CFPB rulemaking and enforcement activities could also result in increased costs related to regulatory oversight, supervision and examination, additional remediation efforts and possible penalties. The CFPB has examination and enforcement authority over financial institutions with more than \$10 billion in total consolidated assets. Banks with \$10 billion or less in total consolidated assets, like HBC, will continue to be examined by their applicable bank regulators.

In California, the DFPI is given broad jurisdiction and sweeping authority that closely resemble those of the CFPB. The DFPI stated that it intends to exercise its powers to protect consumers from unlawful, unfair, deceptive, and abusive practices in connection with consumer financial products or services. The DFPI also as a matter of state law can now enforce Dodd-Frank's UDAAP provisions against any person offering or providing consumer financial products in the state of California. While financial institutions licensed under federal or another state law, such as banks, are excluded from the scope of the laws granting the DFPI such authority, financial institutions in California are likely to be faced with a powerful state financial services regulatory regime with expansive enforcement authority. It is unclear how the DFPI and its broad enforcement activities will affect us going forward.

Financial Privacy. The federal bank regulatory agencies have adopted rules that limit the ability of banks and other financial institutions to disclose non-public information about consumers to non-affiliated third parties. These limitations require disclosure of privacy policies to consumers and, in some circumstances, allow consumers to prevent disclosure of certain personal information to a non-affiliated third party. These regulations affect how consumer information is transmitted through financial services companies and conveyed to outside vendors. In addition, consumers may also prevent disclosure of certain information among affiliated companies that is assembled or used to determine eligibility for a product or service, such as that shown on consumer credit reports and asset and income information from applications. Consumers also have the option to direct banks and other financial institutions not to share information about transactions and experiences with affiliated companies for the purpose of marketing products or services.

The CFPB is expected to embark on rulemaking about consumer control over their financial data. California is also actively enacting legislation relating to data privacy and data protection, such as the California Consumer Privacy Act ("CCPA"). The CCPA granted California consumers robust data privacy rights and control over their personal information, including the right to know, the right to delete, and the right to opt-out of the sale of their personal information. The CCPA was further expanded by the California Privacy Rights Act of 2020 ("CPRA"), which provides additional privacy rights to California residents and creates a new agency tasked with implementing regulations and conducting investigations and enforcement actions. The CPRA became effective on January 1, 2023.

Cybersecurity. The federal bank regulatory agencies have issued multiple statements regarding cybersecurity. This guidance requires financial institutions to design multiple layers of security controls to establish lines of defense and ensure that their risk management processes address the risk posed by

compromised customer credentials and include security measures to authenticate customers accessing internet-based services of the financial institution. The management of a financial institution is expected to maintain sufficient business continuity planning processes to ensure the rapid recovery, resumption and maintenance of operations in the event of a cyber-attack. A financial institution is also expected to develop appropriate processes to enable recovery of data and business operations and address rebuilding network

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capabilities and restoring data if the institution or its critical service providers fall victim to a cyber-attack. If we fail to observe the regulatory guidance, we could be subject to various regulatory sanctions, including financial penalties.

As of May 1, 2022, financial institutions are required to comply with the final rule issued by the federal bank regulatory agencies to improve sharing of information about cyber incidents that may affect the U.S. banking system. The rule requires financial institutions to notify their primary federal regulator of any significant computer-security incidents as soon as possible and no later than 36 hours after they determine that a cyber-incident occurred. Notification is required for incidents that have materially affected (or are reasonably likely to materially affect) the viability of a financial institution's operations, its ability to deliver banking products and services, or the stability of the financial sector. We do not anticipate this rule to have a material impact on the operations of HCC and HBC at this time.

State regulators have also been increasingly active in implementing privacy and cybersecurity standards and regulations. Recently, several states, notably including California where we conduct substantially all our banking business, have adopted laws and/or regulations requiring certain financial institutions to implement cybersecurity programs and providing detailed requirements with respect to these programs, including data encryption requirements. Many such states (including California) have also recently implemented or modified their data breach notification and data privacy requirements. We expect this trend of state-level activity in those areas to continue, and we continue to monitor relevant legislative and regulatory developments in California where nearly all our customers are located.

Incentive Compensation. Dodd-Frank requires the federal banking agencies and the SEC to establish joint regulations or guidelines prohibiting incentive-based payment arrangements at regulated entities with at least \$1 billion in total consolidated assets that encourage inappropriate risks by providing an executive officer, employee, director, or principal shareholder with excessive compensation, fees, or benefits that could lead to material financial loss to the entity. In August 2022, the SEC finalized the pay versus performance regulations, which require disclosure of information that shows the relationship between executive compensation actually paid and the company's financial performance in annual proxy statements. The pay versus performance regulations are effective for fiscal years ending on or after December 16, 2022. Smaller reporting companies are subject to scaled reporting mechanism, and certain companies are exempt from the regulations. In October 2022, the SEC adopted final rules on "clawback" of executive compensation, which direct the stock exchanges to establish listing standards requiring listed companies to develop and implement a policy providing for the recovery of erroneously awarded incentive-based compensation received by current or former executive officers. Under the new rules, companies will have to recover compensation in excess of what the executive officer should have received in the event the companies' financials are restated due to material noncompliance with securities laws. The rules apply to compensation paid in the three years leading up to restatement.

Enforcement Powers of Federal and State Banking Agencies. The federal bank regulatory agencies have broad enforcement powers, including the power to terminate deposit insurance, impose substantial fines and other civil and criminal penalties, and appoint a conservator or receiver for financial institutions. Failure to comply with applicable laws and regulations could subject us and our officers and directors to administrative sanctions and potentially substantial civil money penalties. The DFPI also has broad enforcement powers over us, including the power to impose orders, remove officers and directors, impose fines and appoint supervisors and conservators.

Further Legislative and Regulatory Initiatives. Federal and state legislators as well as regulatory agencies may introduce or enact new laws or rules, or amend existing laws and rules, which may affect the regulation of financial institutions and their holding companies. In addition, some of the financial laws and regulations aiming to ease regulatory and compliance burden on financial institutions that were adopted during the last presidential administration could be repealed or eliminated going forward. The impact of any future legislative or regulatory changes cannot be predicted, but they could affect the Company and HBC's business and operations.

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ITEM 1A. RISK FACTORS

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

Summary of Risk Factors

Risks Related to Our Business

- Unfavorable general business, economic and market conditions
- Ongoing effects of the COVID-19 pandemic
- Geographic concentration in the Greater San Francisco Bay Area
- Monetary policies and regulations
- Fluctuations in interest rates
- Losses on our securities portfolio, particularly from increases in interest rates in our securities available-for-sale portfolio
- Liquidity risks
- Competition for customer deposits

Risks Related to Our Loans

- Negative changes in the economy affecting real estate values and liquidity
- Risks involved with construction and land development loans
- Increased scrutiny by regulators of commercial real estate concentrations
- Unreliability of loan appraisals used in real property loan decisions
- Commercial loans are more sensitive to the borrower's successful operations or property development
- Small and medium business loans are subject to greater risks from adverse business developments
- Underwriting criteria and practices may not prevent poor loan performance

Risks Related to Our SBA Loan Program

- Dependence on U.S. federal government SBA loan program
- Recognition of gains on sale of loans and servicing asset valuations reflect certain assumptions we use
- Credit risks from non-guaranteed portion of SBA loans we retain and do not sell
- Credit risks from SBA loans we sell as a result of repurchase obligations

Risks Related to Our Credit Quality

- Managing credit risk
- Nonperforming assets require management time to resolve and can affect our financial results
- The allowance for credit losses on loans may be insufficient to absorb potential losses in our loan portfolio
- Real estate market volatility may have an adverse effect on disposition of other real estate owned
- Exposure to environmental liabilities on foreclosed real estate collateral

Risks Related to our Growth Strategy

- General risks associated with acquisitions, including availability of suitable targets and integration risks
- Dilution affect resulting from the issuance of common stock consideration for acquisitions
- Impairment of the goodwill recorded from an acquisition
- Incorrect estimate of fair value for assets acquired in an acquisitions
- Managing our branch growth strategy
- Managing risks of adding new lines of business and new products

Risks Related to Our Capital

- More stringent capital requirements

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- Raising new capital in conditions beyond our control

Risks Related to Management

- Our success depends on the skills and retention of our management
- Competition for skilled and experienced management level and senior level employees

Risks Related to Our Reputation and Operations

- Failure to maintain a favorable reputation with our customers and communities
- Failure of our risk management framework
- Interruptions, cyber-attacks, fraud and other security breaches
- Difficulties from our third-party providers
- Employee misconduct
- Inaccurate information provided to us by customers or counterparties
- Environmental, social and governance practices

Risks from Competition

- Competition from financial service companies and other companies that offer commercial banking services
- Competitive need to implement new technology and related operational challenges

Risks Related to Other Business

- Costs and effects of litigation, investigations or similar matters
- Phasing out of and uncertainty related to London Interbank Offered Rate (“LIBOR”)
- The soundness of other financial institutions
- Severe weather, natural disasters (including fire and earthquakes, pandemics, acts of war, terrorism, and social unrest)
- Climate change

Risks Related to Finance and Accounting

- Reliance on estimates and risk management processes and analytical and forecasting models
- Changes in accounting standards
- Failure to maintain effective internal controls over financial reporting
- Realization of our deferred tax assets

Risks Related to Legislative and Regulatory Developments

- Extensive government regulation that could limit or restrict our activities
- Legislative and regulatory actions now or in the future increase our costs, and impact our business
- Federal and state regulatory exams
- Noncompliance with the BSA and other anti-money laundering statutes and regulations
- Consumer protection laws and regulations
- Failure to comply with privacy, data protection and information security legal requirements

Risks Related to Our Common Stock

- Investment in common stock is not an insured deposit
- Volatile trading price of our common stock
- Limited trading volume
- Changes in dividend policy
- Limitations on director liability for monetary damages for failure to exercise their fiduciary duty
- Potential dilution from issuance of additional equity securities
- Issuance of preferred stock which may have rights and preferences over our common stock
- Failure to satisfy our obligations under our subordinated notes would preclude the payment of dividends
- Our charter documents and California law may have an anti-takeover effect limiting changes of control

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Risks Relating to Our Business

Our Business could be adversely affected by unfavorable economic and market conditions.

Our business and operations are sensitive to general business and economic conditions in the United States, generally, and particularly the state of California and our market area. Unfavorable or uncertain economic and market conditions could lead to credit quality concerns related to borrower repayment ability and collateral protection as well as reduced demand for the products and services we offer. These economic conditions can arise suddenly, as did the conditions associated with the COVID-19 pandemic, and the full impact of such conditions can be difficult to predict. In addition, geopolitical and domestic political developments, such as existing and potential trade wars and other events beyond our control, can increase levels of political and economic unpredictability globally and increase the volatility of financial markets.

Concerns about the performance of international economies, especially in Europe and emerging markets, and economic conditions in Asia, can impact the economy and financial markets here in the United States. If the national, regional and local economies experience worsening economic conditions, including declining growth and high levels of unemployment, our growth and profitability could be constrained. Weak economic conditions are characterized by, among other indicators, deflation, inflation, elevated levels of unemployment, fluctuations in debt and equity capital markets, increased delinquencies on mortgage, commercial and consumer loans, residential and commercial real estate price declines, related vacancy rates, and lower home sales and commercial activity. Various market conditions may also negatively affect our operating results. Real estate market conditions directly affect performance of our loans secured by real estate. Debt markets affect the availability of credit, which affects the rates and terms at which we offer loans and leases. Stock market downturns affect businesses' ability to raise capital and invest in business expansion. Stock market downturns often signal broader economic deterioration and/or a downward trend in business earnings, which adversely affects businesses' ability to service their debts.

There can be no assurance that economic conditions will improve, and these conditions could worsen. Economic pressure on consumers and uncertainty regarding continuing economic improvement may result in changes in consumer and business spending, borrowing and saving habits. Such conditions could have a material adverse effect on the credit quality of our loans or our business, financial condition and results and operations.

An economic recession or a downturn in various markets could have one or more of the following adverse effects on our business:

- a decrease in the demand for our loan or other products and services offered by us;
- a decrease in our deposit balances due to an overall reduction in customer balances;
- a decrease in the value of our investment securities and loans;
- an increase in the level of nonperforming and classified loans;
- an increase in the provision for credit losses and loan and lease charge-offs;
- a decrease in net interest income derived from our lending and deposit gathering activities;
- a decrease in the Company's stock price;
- an increase in our operating expenses associated with attending to the effects of the above-listed circumstances; and/or
- a decrease in real estate values or a general decrease in capital available to finance real estate transactions, which could have a negative impact on borrowers' ability to pay off their loans as they mature.

The COVID-19 pandemic has in the past negatively affected, and could in the future negatively affect, the global and U.S. economies could harm our business and results of operations, and such effects will depend on future developments, which are highly uncertain and are difficult to predict.

The COVID-19 pandemic has in the past negatively affected, and could in the future negatively affect, the global and U.S. economies, including by increasing unemployment levels, disrupting supply chains and businesses in many industries, lowering equity market valuations, decreasing liquidity in fixed income

markets, and creating significant volatility and disruption in financial markets. The extent to which the COVID-19 pandemic could adversely affect our business, financial condition and results of operations, as well as our liquidity and capital profile, and provisions for credit

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losses, will depend on future developments, which are highly uncertain and cannot be predicted, including the scope and duration of the pandemic, any resurgence of COVID-19 cases and the emergence of new variants, the widespread availability, use and effectiveness of vaccines, actions taken by governmental authorities and other third parties in response to the pandemic and the direct and indirect impact of the pandemic on us, our clients and customers, our service providers and other market participants. As the COVID-19 pandemic adversely affects us, it may also have the effect of heightening many of the other risks described herein.

Our profitability is dependent upon the geographic concentration of the markets in which we operate.

We operate primarily in the general San Francisco Bay Area of California in the counties of Alameda, Contra Costa, Marin, San Benito, San Francisco, San Mateo, and Santa Clara and, as a result, our business, financial condition and results of operations are subject to the demand for our products in those areas and is also subject to changes in the economic conditions in those areas. Our success depends upon the business activity, population, income levels, deposits and real estate activity in these markets. Although our customers' business and financial interests may extend well beyond these market areas, adverse economic conditions that affect these market areas could reduce our growth rate, affect the ability of our customers to repay their loans to us and generally affect our business, financial condition and results of operations. Because of our geographic concentration, we are less able than regional or national financial institutions to diversify demand for our products or our credit risks across multiple markets.

Monetary policies and regulations of the Federal Reserve could adversely affect our business, financial condition and results of operations.

In addition to being affected by general economic conditions, our earnings and growth are affected by the policies of the Federal Reserve. An important function of the Federal Reserve is to regulate the money supply and credit conditions. Among the instruments used by the Federal Reserve to implement these objectives are open market purchases and sales of U.S. government securities, adjustments of the discount rate and changes in banks' reserve requirements against bank deposits. These instruments are used in varying combinations to influence overall economic growth and the distribution of credit, bank loans, investments and deposits. Their use also affects interest rates charged on loans or paid on deposits. The monetary policies and regulations of the Federal Reserve 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.

Fluctuations in interest rates may reduce net interest income and otherwise negatively affect our business, financial condition and results of operations.

Shifts in short-term interest rates may reduce net interest income, which is the principal component of our earnings. Net interest income is the difference between the amounts received by us on our interest-earning assets and the interest paid by us on our interest-bearing liabilities. When interest rates rise, the rate of interest we receive on our assets, such as floating interest rate loans, rises more quickly than the rate of interest that we pay on our interest-bearing liabilities, such as deposits, which may cause our profits to increase. When interest rates decrease, the rate of interest we receive on our assets, such as floating interest rate loans, declines more quickly than the rate of interest that we pay on our interest-bearing liabilities, such as deposits, which may cause our profits to decrease.

Changes in interest rates could influence our ability to originate loans and deposits. Historically, there has been an inverse correlation between the demand for loans and interest rates. Loan origination volume usually declines during periods of rising or high interest rates and increases during periods of declining or low interest rates.

Changes in interest rates can also affect the level of loan refinancing activity, which impacts the amount of prepayment penalty income we receive on loans we hold. Because prepayment penalties are recorded as interest income when received, the extent to which they increase or decrease during any given period could have a significant impact on the level of net interest income and net income we generate during that time. A decrease in our prepayment penalty income resulting from any change in interest rates or as a

result of regulatory limitations on our ability to charge prepayment penalties could therefore adversely affect our net interest income, net income or results of operations.

An increase in interest rates that adversely affects the ability of borrowers to pay the principal or interest on loans may lead to an increase in nonperforming assets and a reduction of income recognized, which could have a material adverse

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effect on our results of operations and cash flows. Further, when we place a loan on nonaccrual status, we reverse any accrued but unpaid interest receivable, which decreases interest income. Subsequently, we continue to have a cost to fund the loan, which is reflected as interest expense, without any interest income to offset the associated funding expense. Thus, an increase in the amount of nonperforming assets would have an adverse impact on net interest income.

Changes in interest rates also can affect the value of loans, securities and other assets. Rising interest rates will result in a decline in value of the fixed-rate debt securities we hold in our investment securities portfolio. The unrealized losses resulting from holding these securities would be recognized in accumulated other comprehensive income and reduce total shareholders' equity. Unrealized losses do not negatively impact our regulatory capital ratios. However, tangible common equity and the associated ratios would be reduced. If debt securities in an unrealized loss position are sold, such losses become realized and will reduce our regulatory capital ratios.

We could recognize losses on securities held in our securities portfolio, particularly if interest rates increase or economic and market conditions deteriorate.

As of December 31, 2022, the fair value of our securities portfolio was approximately \$1.1 billion. Factors beyond our control can significantly influence the fair value of securities in our portfolio and can cause potential adverse changes to the fair value of these securities. For example, fixed-rate securities acquired by us are generally subject to decreases in market value when interest rates rise. Additional factors include, but are not limited to, rating agency downgrades of the securities or our own analysis of the value of the security, defaults by the issuer or individual mortgagors with respect to the underlying securities, and continued instability in the credit markets. Any of the foregoing factors could cause credit-related impairment in future periods and result in realized losses. The process for determining whether impairment is credit related usually requires difficult, subjective judgments about the future financial performance of the issuer and any collateral underlying the security in order to assess the probability of receiving all contractual principal and interest payments on the security. Because of changing economic and market conditions affecting interest rates, we may recognize realized and/or unrealized losses in future periods, which could have a material adverse effect on our business, financial condition and results of operations.

Liquidity risks could affect operations and jeopardize our business, financial condition, and results of operations.

Liquidity is essential to our business. An inability to raise funds through deposits, borrowings, the sale of loans and/or investment securities, and from other sources could have a substantial negative effect on our liquidity. Our most important source of funds consists of our customer deposits. Such deposit balances can decrease when customers perceive alternative investments are providing a better risk/return tradeoff. If customers move money out of bank deposits and into other investments, we could lose a relatively low cost source of funds, thereby increasing our funding costs and reducing net interest income and net income. We could have to raise interest rates to retain deposits, thereby increasing our funding costs and reducing net interest income and net income.

Additional liquidity is provided by our ability to borrow from the Federal Reserve Bank of San Francisco and the Federal Home Loan Bank of San Francisco. We also may borrow from third-party lenders from time to time. Our access to funding sources in amounts adequate to finance or capitalize our activities on terms that are acceptable to us could be impaired by factors that affect us directly or the financial services industry or economy in general, such as disruptions in the financial markets or negative views and expectations about the prospects for the financial services industry.

Any decline in available funding could adversely impact our ability to continue to implement our strategic plan, including our ability to originate loans, invest in securities, meet our expenses, or to fulfill obligations such as repaying our borrowings or meeting deposit withdrawal demands, any of which could have a material adverse effect on our liquidity, business, financial condition and results of operations.

Competition among U.S. banks for customer deposits is intense, may increase the cost of retaining current deposits or procuring new deposits, and may otherwise negatively affect our ability to grow our deposit base.

Competition among U.S. banks for customer deposits is intense, may increase the cost of retaining current deposits or procuring new deposits, and may otherwise negatively affect our ability to grow our deposit base. Maintaining and attracting new deposits is integral to our business and a major decline in deposits or failure to attract deposits in the

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future, including any such decline or failure related to an increase in interest rates paid by our competitors on interest-bearing accounts, could have an adverse effect on our business, financial conditions and results of operations. Interest-bearing accounts earn interest at rates established by management based on competitive market factors. The demand for the deposit products we offer may also be reduced due to a variety of factors, such as demographic patterns, changes in customer preferences, reductions in consumers' disposable income, regulatory actions that decrease customer access to particular products, or the availability of competing products.

Risks Related to Our Loans

Because a significant portion of our loan portfolio is comprised of real estate loans, negative changes in the economy affecting real estate values and liquidity could impair the value of collateral securing our real estate loans and result in loan and other losses.

Real estate lending (including commercial, land development and construction, home equity, multifamily, and residential mortgage loans) is a large portion of our loan portfolio. At December 31, 2022, approximately \$2.748 billion, or 83% of our loan portfolio, was comprised of loans with real estate as a primary or secondary component of collateral. Included in CRE loans were owner occupied loans of \$614.7 million, or 19% of total loans. The real estate securing our loan portfolio is concentrated in California. The market value of real estate can fluctuate significantly in a short period of time as a result of market conditions in the geographic area in which the real estate is located. Real estate values and real estate markets are generally affected by changes in national, regional or local economic conditions, the rate of unemployment, fluctuations in interest rates and the availability of loans to potential purchasers, fluctuations in vacancy rates, changes in tax laws and other governmental statutes, regulations and policies and acts of nature, such as earthquakes and other natural disasters. Adverse changes affecting real estate values and the liquidity of real estate in one or more of our markets could increase the credit risk associated with our loan portfolio, significantly impair the value of property pledged as collateral on loans and affect our ability to sell the collateral upon foreclosure without a loss or additional losses, which would adversely affect profitability. Such declines and losses would have a material adverse effect on our business, financial condition, and results of operations.

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

At December 31, 2022, land and construction loans, (including land acquisition and development loans) totaled \$163.6 million or 5% of our portfolio. Of these loans, 9% were comprised of owner occupied and 91% non-owner occupied construction and land loans. These loans involve additional risks because funds are advanced upon the security of the project, which is of uncertain value prior to its completion, and costs may exceed realizable values in declining real estate markets. Because of the uncertainties inherent in estimating construction costs and the realizable market value of the completed project and the effects of governmental regulation of real property, it is relatively difficult to evaluate accurately the total funds required to complete a project and the related loan-to-value ratio. As a result, construction loans often involve the disbursement of substantial funds with repayment dependent, in part, on the success of the ultimate project and the ability of the borrower to sell or lease the property, rather than the ability of the borrower or guarantor to repay principal and interest. If our appraisal of the value of the completed project proves to be overstated or market values or rental rates decline, we may have inadequate security for the repayment of the loan upon completion of project construction. If we are forced to foreclose on a project prior to or at completion due to a default, we may not be able to recover all of the unpaid balance of, and accrued interest on, the loan as well as related foreclosure and holding costs. In addition, we may be required to fund additional amounts to complete the project and may have to hold the property for an unspecified period of time while we attempt to dispose of it.

Increased scrutiny by regulators of commercial real estate concentrations could restrict our activities and impose financial requirements or limits on the conduct of our business.

Banking regulators are giving commercial real estate lending greater scrutiny, and may require banks with higher levels of commercial real estate loans to implement improved underwriting, internal controls, risk management policies and portfolio stress testing, as well as possibly higher levels of allowances for credit losses on loans and capital levels as

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a result of commercial real estate lending growth and exposures. Therefore, we could be required to raise additional capital or restrict our future growth as a result of our higher level of commercial real estate loans.

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

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

Many of our loans are to commercial borrowers, which may have a higher degree of risk than other types of borrowers.

At December 31, 2022, commercial loans totaled \$533.9 million or 16% of our loan portfolio (including SBA loans, PPP loans, asset-based lending, and factored receivables). Commercial loans represented 22% of our total loan portfolio at December 31, 2021. Commercial loans are often larger and involve greater risks than other types of lending. Because payments on such loans are often dependent on the successful operation or development of the property or business involved, repayment of such loans is often more sensitive than other types of loans to adverse conditions in the real estate market or the general business climate and economy. Accordingly, a downturn in the real estate market and a challenging business and economic environment may increase our risk related to commercial loans, particularly commercial real estate loans. Unlike home mortgage loans, which generally are made on the basis of the borrowers' ability to make repayment from their employment and other income and which are secured by real property whose value tends to be more easily ascertainable, commercial loans typically are made on the basis of the borrowers' ability to make repayment from the cash flow of the commercial venture. Our commercial and industrial loans are primarily made based on the identified cash flow of the borrower and secondarily on the collateral underlying the loans. Most often, collateral consists of accounts receivable, inventory and equipment. Inventory and equipment may depreciate over time, may be difficult to appraise and may fluctuate in value based on the success of the business. Accounts receivable may be uncollectable. If the cash flow from business operations is reduced, the borrower's ability to repay the loan may be impaired. Vacancy rates can also negatively impact cash flows from business operations. Due to the larger average size of each commercial loan as compared with other loans such as residential loans, as well as collateral that is generally less readily-marketable, losses incurred on a small number of commercial loans could have a material adverse effect on our business, financial condition and results of operations.

The small and medium-sized businesses that we lend to may have fewer resources to weather adverse business developments, which may impair a borrower's ability to repay a loan, and such impairment could adversely affect our business, financial condition and results of operation.

We target our business development and marketing strategy primarily to serve the banking and financial services needs of small to medium-sized businesses. These businesses generally have fewer financial resources in terms of capital or borrowing capacity than larger entities, frequently have smaller market shares than their competition, may be more vulnerable to economic downturns, often need substantial additional capital to expand or compete and may experience substantial volatility in operating results, any of which may impair a borrower's ability to repay a loan. In addition, the success of a small and medium-sized business often depends on the management talents and efforts of one or two people or a small group of people, and the death, disability or resignation of one or more of these people could have a material adverse impact on the business and its ability to repay its loan. Negative general economic conditions in our markets where we operate that adversely affect our medium-sized business borrowers may impair the borrower's ability to repay a loan and such impairment could have a material adverse effect on our business, financial condition and results of operation.

We may suffer losses in our loan portfolio despite our underwriting practices.

We mitigate the risks inherent in our loan portfolio by adhering to sound and proven underwriting practices, managed by experienced and knowledgeable credit professionals. These practices include analysis of a borrower's prior credit history, financial statements, tax returns, and cash flow projections, valuations of collateral based on reports of

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independent appraisers and verifications of liquid assets. Nonetheless, we may incur losses on loans that meet our underwriting criteria, and these losses may exceed the amounts set aside as reserves in our allowance for loan loss.

Risks Related to our SBA Loan Program

Small Business Administration lending is an important part of our business. Our SBA lending program is dependent upon the U.S. federal government, and we face specific risks associated with originating SBA loans.

At December 31, 2022, SBA loans totaled \$40.2 million, which are included in the commercial loan portfolio, and SBA loans held-for-sale totaled \$2.4 million. In addition, the Company had \$1.2 million of SBA PPP loans at December 31, 2022. Our SBA lending program is dependent upon the U.S. federal government. As an approved participant in the SBA Preferred Lender's Program (an "SBA Preferred Lender"), we enable our clients to obtain SBA loans without being subject to the potentially lengthy SBA approval process necessary for lenders that are not SBA Preferred Lenders. The SBA periodically reviews the lending operations of participating lenders to assess, among other things, whether the lender exhibits prudent risk management. When weaknesses are identified, the SBA may request corrective actions or impose enforcement actions, including revocation of the lender's SBA Preferred Lender status. If we lose our status as an SBA Preferred Lender, we may lose some or all of our customers to lenders who are SBA Preferred Lenders, and as a result we could experience a material adverse effect to our financial results. Any changes to the SBA program, including but not limited to changes to the level of guarantee provided by the federal government on SBA loans, changes to program specific rules impacting volume eligibility under the guaranty program, as well as changes to the program amounts authorized by Congress may also have a material adverse effect on our business. In addition, any default by the U.S. government on its obligations or any prolonged government shutdown could, among other things, impede our ability to originate SBA loans or sell such loans in the secondary market, which could have a material adverse effect on our business, financial condition and results of operations.

The SBA's 7(a) Loan Program is the SBA's primary program for helping start-up and existing small businesses, with financing guaranteed for a variety of general business purposes. Generally, we sell the guaranteed portion of our SBA 7(a) loans in the secondary market. These sales result in premium income for us at the time of sale and create a stream of future servicing income, as we retain the servicing rights to these loans. For the reasons described above, we may not be able to continue originating these loans or sell them in the secondary market. Furthermore, even if we are able to continue to originate and sell SBA 7(a) loans in the secondary market, we might not continue to realize premiums upon the sale of the guaranteed portion of these loans or the premiums may decline due to economic and competitive factors. When we originate SBA loans, we incur credit risk on the non-guaranteed portion of the loans, and if a customer defaults on a loan, we share any loss and recovery related to the loan pro-rata with the SBA. If the SBA establishes that a loss on an SBA guaranteed loan is attributable to significant technical deficiencies in the manner in which the loan was originated, funded or serviced by us, the SBA may seek recovery of the principal loss related to the deficiency from us. Generally, we do not maintain reserves or loss allowances for such potential claims and any such claims could materially adversely affect our business, financial condition and results of operations.

In addition, the Company's SBA loans include loans under the U.S. Department of Agriculture guaranteed lending programs.

The laws, regulations and standard operating procedures that are applicable to SBA loan products may change in the future. We cannot predict the effects of these changes on our business and profitability. Because government regulation greatly affects the business and financial results of all commercial banks and bank holding companies and especially our organization, changes in the laws, regulations and procedures applicable to SBA loans could adversely affect our ability to operate profitably.

The recognition of gains on the sale of loans and servicing asset valuations reflect certain assumptions.

We expect that gains on the sale of U.S. government guaranteed loans will contribute to noninterest income. The gains on such sales recognized for the year ended December 31, 2022 was \$491,000. The determination of these gains is based on assumptions regarding the value of unguaranteed loans retained, servicing rights retained and deferred fees and costs, and net premiums paid by purchasers of the guaranteed portions of U.S. government guaranteed loans. The value of retained unguaranteed loans and servicing rights are determined based on market derived factors such as prepayment rates,

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current market conditions and recent loan sales. Deferred fees and costs are determined using internal analysis of the cost to originate loans. Significant errors in assumptions used to compute gains on sale of loans or servicing asset valuations could result in material revenue misstatements, which may have a material adverse effect on our business, financial condition and results of operations.

We originated \$21.2 million of SBA loans for the year ended December 31, 2022. We sold \$7.2 million of the guaranteed portion of our SBA loans for the year ended December 31, 2022. We generally retain the non-guaranteed portions of the SBA loans that we originate. Consequently, as of December 31, 2022, we held \$40.2 million of SBA loans (including loans held-for-sale) on our balance sheet, \$24.0 million of which consisted of the non-guaranteed portion of SBA loans, and \$16.1 million of which consisted of the guaranteed portion of SBA loans. At December 31, 2022, \$2.5 million, or 6.1%, consisted of the guaranteed portion of SBA loans which we intend to sell in 2023. The non-guaranteed portion of SBA loans have a higher degree of credit risk and risk of loss as compared to the guaranteed portion of such loans and make up a substantial majority of our remaining SBA loans.

When we sell the guaranteed portion of SBA loans in the ordinary course of business, we are required to make certain representations and warranties to the purchaser about the SBA loans and the manner in which they were originated. Under these agreements, we may be required to repurchase the guaranteed portion of the SBA loan if we have breached any of these representations or warranties, in which case we may record a loss. In addition, if repurchase and indemnity demands increase on loans that we sell from our portfolios, our liquidity, results of operations and financial condition could be adversely affected. Further, we generally retain the non-guaranteed portions of the SBA loans that we originate and sell, and to the extent the borrowers of such loans experience financial difficulties, our financial condition and results of operations could be adversely impacted.

Risks Related to our Credit Quality

Our business depends on our ability to successfully manage credit risk.

The operation of our business requires us to manage credit risk. As a lender, we are exposed to the risk that our borrowers will be unable to repay their loans according to their terms, and that the collateral securing repayment of their loans, if any, may not be sufficient to ensure repayment. In addition, there are risks inherent in making any loan, including risks with respect to the period of time over which the loan may be repaid, risks relating to proper loan underwriting, risks resulting from changes in economic and industry conditions and risks inherent in dealing with individual borrowers. In order to successfully manage credit risk, we must, among other things, maintain disciplined and prudent underwriting standards and ensure that our bankers follow those standards. The weakening of these standards for any reason, a lack of discipline or diligence by our employees in underwriting and monitoring loans, the inability of our employees to adequately adapt policies and procedures to changes in economic or any other conditions affecting borrowers and the quality of our loan portfolio, may result in loan defaults, foreclosures and additional charge-offs and may necessitate that we significantly increase our allowance for credit losses on loans, each of which could adversely affect our net income. As a result, our inability to successfully manage credit risk could have a material adverse effect on our business, financial condition and results of operations.

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

As of December 31, 2022, our nonperforming loans (which consist of nonaccrual loans, loans past due 90 days or more and still accruing interest and loans modified under troubled debt restructurings) totaled \$2.4 million, or 0.07% of our loan portfolio, and our nonperforming assets (which include nonperforming loans plus other real estate owned) totaled \$2.4 million, or 0.05% of total assets.

Our nonperforming assets adversely affect our net income in various ways. We do not record interest income on nonaccrual loans or other real estate owned, thereby adversely affecting our net interest income, net income and returns on assets and equity, and our loan administration costs increase, which together with reduced interest income adversely affects our efficiency ratio. Further, when we place a loan on nonaccrual

status, we reverse any accrued but unpaid interest receivable, which decreases interest income. Subsequently, we continue to have a cost to fund the loan, which is reflected as interest expense, without any interest income to offset the associated funding expense. When we take collateral in

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foreclosure and similar proceedings, we are required to mark the collateral to its then-fair market value, which may result in a loss. These nonperforming loans and other real estate owned also increase our risk profile and the level of capital our regulators believe is appropriate for us to maintain in light of such risks. The resolution of nonperforming assets requires significant time commitments from management and can be detrimental to the performance of their other responsibilities. If we experience increases in nonperforming loans and nonperforming assets, our net interest income may be negatively impacted and our loan administration costs could increase, each of which could have a material adverse effect on our business, financial condition and results of operations.

Our allowance for credit losses on loans may prove to be insufficient to absorb potential losses in our loan portfolio.

We maintain an allowance for credit losses on loans to provide for loan defaults and non-performance. This allowance, expressed as a percentage of loans, was 1.44%, at December 31, 2022. Allowance for credit losses on loans is funded from a provision for credit losses on loans, which is a charge to our income statement. The Company had a provision for credit losses on loans of \$766,000 for the year ended December 31, 2022. The allowance for credit losses on loans reflects our estimate of the current expected credit losses in our loan portfolio at the relevant balance sheet date. Our allowance for credit losses on loans is based on our prior experience, as well as an evaluation of the known risks in the current portfolio, composition and growth of the loan portfolio and economic forecasts for correlated economic factors. The determination of an appropriate level of allowance for credit losses on loans is an inherently difficult and subjective process, requiring complex judgments, and is based on numerous analytical assumptions. The amount of future losses is susceptible to changes in economic and other conditions, including changes in interest rates, changes in economic forecasts, changes in the financial condition of borrowers, and deteriorating values of collateral that may be beyond our control, and these losses may exceed current estimates. The allowance is only an estimate of the probable incurred losses in the loan portfolio and may not represent actual over time, either of losses in excess of the allowance or of losses less than the allowance.

In addition, we evaluate all loans identified as impaired loans and allocate an allowance based upon our estimation of the potential loss associated with those problem loans. While we strive to carefully manage and monitor credit quality and to identify loans that may be deteriorating, at any time there are loans included in the portfolio that may result in losses, but that have not yet been identified as nonperforming or potential problem loans. Through established credit practices, we attempt to identify deteriorating loans and adjust the allowance for credit losses on loans accordingly. However, because future events are uncertain and because we may not successfully identify all deteriorating loans in a timely manner, there may be loans that deteriorate in an accelerated time frame. We cannot be sure that we will be able to identify deteriorating loans before they become nonperforming assets, or that we will be able to limit losses on those loans that have been so identified.

Although management believes that the allowance for credit losses on loans is adequate to absorb losses on any existing loans that may become uncollectible, we may be required to take additional provisions for credit losses on loans in the future to further supplement the allowance for credit losses on loans, either due to management's decision to do so or because our banking regulators require us to do so. Our bank regulatory agencies will periodically review our allowance for credit losses on loans and the value attributed to nonaccrual loans or to real estate acquired through foreclosure and may require us to adjust our determination of the value for these items. If our allowance for credit losses on loans is inaccurate, for any of the reasons discussed above (or other reasons), and is inadequate to cover the loan losses that we actually experience, the resulting losses could have a material adverse effect on our business, financial condition and results of operations.

Real estate market volatility and future changes in our disposition strategies could result in net proceeds that differ significantly from our other real estate owned fair value appraisals.

As of December 31, 2022 we had no other real estate owned ("OREO") on our financial statements, but in the ordinary course of our business we expect to hold some level of OREO from time to time. OREO typically consists of properties that we obtain through foreclosure or through an in-substance foreclosure in

satisfaction of an outstanding loan. OREO properties are valued on our books at the lesser of the recorded investment in the loan for which the property previously served as collateral or the property's "fair value," which represents the estimated sales price of the property on the date acquired less estimated selling costs. Generally, in determining "fair value," an orderly disposition of the property is assumed, unless a different disposition strategy is expected. Significant judgment is required in estimating the fair value

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of OREO property, and the period of time within which such estimates can be considered current is significantly shortened during periods of market volatility.

In response to market conditions and other economic factors, we may utilize alternative sale strategies other than orderly disposition as part of our OREO disposition strategy, such as immediate liquidation sales. In this event, as a result of the significant judgments required in estimating fair value and the variables involved in different methods of disposition, the net proceeds realized from such sales transactions could differ significantly from the appraisals, comparable sales and other estimates used to determine the fair value of our OREO properties.

We could be exposed to risk of environmental liabilities with respect to properties to which we take title.

In the course of our business, we may foreclose and take title to real estate, and could be subject to environmental liabilities with respect to these properties. We may be held liable to a governmental entity or to third-parties for property damage, personal injury, investigation and clean-up costs incurred by these parties in connection with environmental contamination, or may be required to investigate or clean up hazardous or toxic substances, or chemical releases at a property. The costs associated with investigation or remediation activities could be substantial. In addition, if we are the owner or former owner of a contaminated site, we may be subject to common law claims by third-parties based on damages and costs resulting from environmental contamination emanating from the property. Significant environmental liabilities could have a material adverse effect on our business, financial condition, and results of operations.

Risks Related to Our Growth Strategy

There are risks related to acquisitions.

We plan to continue to grow our business organically. However, from time to time, we may consider opportunistic strategic acquisitions that we believe support our long-term business strategy. We face significant competition from numerous other financial services institutions, many of which will have greater financial resources than we do, when considering acquisition opportunities. Accordingly, attractive acquisition opportunities may not be available to us. We may not be successful in identifying or completing any future acquisitions. Acquisitions of financial institutions involve operational risks and uncertainties and acquired companies may have unforeseen liabilities, exposure to asset quality problems, key employee and customer retention problems and other problems that could negatively affect our organization.

If we complete any future acquisitions, we may not be able to successfully integrate the operations, management, products and services of the entities that we acquire and eliminate redundancies. The integration process could result in the loss of key employees or disruption of the combined entity's ongoing business or inconsistencies in standards, controls, procedures, and policies that adversely affect our ability to maintain relationships with customers and employees or achieve the anticipated benefits of the transaction. The integration process may also require significant time and attention from our management that they would otherwise direct at servicing existing business and developing new business. We may not be able to realize any projected cost savings, synergies or other benefits associated with any such acquisition we complete. We cannot determine all potential events, facts and circumstances that could result in loss and our investigation or mitigation efforts may be insufficient to protect against any such loss.

In addition, we must generally satisfy a number of meaningful conditions prior to completing any acquisition, including, in certain cases, federal and state bank regulatory approval. Bank regulators consider a number of factors when determining whether to approve a proposed transaction, including the effect of the transaction on financial stability and the ratings and compliance history of all institutions involved, including the CRA, examination results and anti-money laundering and Bank Secrecy Act compliance records of all institutions involved. The process for obtaining required regulatory approvals has become substantially more difficult, which could affect our future business. We may fail to pursue, evaluate or complete strategic and competitively significant business opportunities as a result of our inability, or our perceived inability, to obtain any required regulatory approvals in a timely manner or at all.

Issuing additional shares of our common stock to acquire other banks and bank holding companies may result in dilution for existing shareholders and may adversely affect the market price of our stock.

In connection with our growth strategy, we have issued, and may issue in the future, shares of our common

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stock to acquire additional banks or bank holding companies that may complement our organizational structure. Resales of substantial amounts of common stock in the public market and the potential of such sales could adversely affect the prevailing market price of our common stock and impair our ability to raise additional capital through the sale of equity securities. We sometimes must pay an acquisition premium above the fair market value of acquired assets for the acquisition of banks or bank holding companies. Paying this acquisition premium, in addition to the dilutive effect of issuing additional shares, may also adversely affect the prevailing market price of our common stock.

If the goodwill that we recorded in connection with a business acquisition becomes impaired, it could require charges to earnings, which would have a negative impact on our financial condition and results of operations.

Goodwill represents the amount by which the cost of an acquisition exceeded the fair value of net assets we acquired in connection with the purchase. We review goodwill for impairment at least annually, or more frequently if events or changes in circumstances indicate that the carrying value of the asset might be impaired. We determine impairment by comparing the implied fair value of the reporting unit goodwill with the carrying amount of that goodwill. Estimates of fair value are determined based on a complex model using cash flows, the fair value of our Company as determined by our stock price, and company comparisons. If management's estimates of future cash flows are inaccurate, fair value determined could be inaccurate and impairment may not be recognized in a timely manner. If the carrying amount of the reporting unit goodwill exceeds the implied fair value of that goodwill, an impairment loss is recognized in an amount equal to that excess. Any such adjustments are reflected in our results of operations in the periods in which they become known. There can be no assurance that our future evaluations of goodwill will not result in findings of impairment and related write-downs, which may have a material adverse effect on our financial condition and results of operations.

Our decisions regarding the fair value of assets acquired could be different than initially estimated, which could materially and adversely affect our business, financial condition and results of operations.

In business combinations, we acquire significant portfolios of loans that are marked to their estimated fair value. There is no assurance that the acquired loans will not suffer deterioration in value. The fluctuations in national, regional and local economic conditions, including those related to local residential, commercial real estate and construction markets, may increase the level of charge offs in the loan portfolio that we acquire and correspondingly reduce our net income. These fluctuations are not predictable, cannot be controlled and may have a material adverse effect on our business, financial condition, and results of operations.

We must effectively manage our branch growth strategy.

We seek to expand our franchise safely and consistently. A successful growth strategy requires us to manage multiple aspects of our business simultaneously, such as following adequate loan underwriting standards, balancing loan and deposit growth without increasing interest rate risk or compressing our net interest margin, maintaining sufficient capital, maintaining proper system and controls, and recruiting, training and retaining qualified professionals. We also may experience a lag in profitability associated with new branch openings. As part of our general growth strategy we may expand into additional communities or attempt to strengthen our position in our current markets by opening new offices, subject to any regulatory constraints on our ability to open new offices. To the extent that we are able to open additional offices, we are likely to experience the effects of higher operating expenses relative to operating income from the new operations for a period of time which could have a material adverse effect on our business, financial condition and results of operations.

New lines of business or new products and services may subject us to additional risks.

From time to time, we may implement or may acquire new lines of business or offer new products and services within existing lines of business. There are substantial risks and uncertainties associated with these efforts, particularly in instances where the markets are not fully developed. In developing and marketing new lines of business and new products and services we may invest significant time and resources. We may

not achieve target timetables for the introduction and development of new lines of business and new products or services and price and profitability targets may not prove feasible. External factors, such as regulatory compliance obligations, competitive alternatives, and shifting market preferences, may also impact the successful implementation of a new line of business or a new product or service. Furthermore, any new line of business and/or new product or service could have a significant impact on the effectiveness

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of our system of internal controls. Failure to successfully manage these risks in the development and implementation of new lines of business or new products or services could have a material adverse effect on our business, financial condition and results of operations.

Risks Related to Our Capital

We may be subject to more stringent capital requirements in the future.

We are subject to current and changing regulatory requirements specifying minimum amounts and types of capital that we must maintain. The failure to meet applicable regulatory capital requirements could result in one or more of our regulators placing limitations or conditions on our activities, including our growth initiatives, or restricting the commencement of new activities, and could affect customer and investor confidence, our costs of funds and FDIC insurance costs, our ability to pay dividends on our common stock, our ability to make acquisitions, and could materially adversely affect our business, financial condition and results of operations.

We may need to raise additional capital in the future, and if we fail to maintain sufficient capital, whether due to losses, an inability to raise additional capital or otherwise, our financial condition, liquidity and results of operations, as well as our ability to maintain regulatory compliance, would be adversely affected.

We face significant capital and other regulatory requirements as a financial institution. We may need to raise additional capital in the future to provide us with sufficient capital resources and liquidity to meet our commitments and business needs, which could include the possibility of financing acquisitions. Our ability to raise additional capital depends on conditions in the capital markets, economic conditions and a number of other factors, including investor perceptions regarding the banking industry, market conditions and governmental activities, and on our financial condition and performance. Any occurrence that may limit our access to the capital markets may adversely affect our capital costs and our ability to raise capital. Moreover, if we need to raise capital in the future, we may have to do so when many other financial institutions are also seeking to raise capital and would have to compete with those institutions for investors. We, therefore, may not be able to raise additional capital if needed or on terms acceptable to us.

Risks Related to our Management

We are highly dependent on our management team, and the loss of our senior executive officers or other key employees could harm our ability to implement our strategic plan, impair our relationships with customers and adversely affect our business, financial condition and results of operations.

Our success depends, in large degree, on the skills of our management team and our ability to retain, recruit and motivate key officers and employees. Our senior management team has significant industry experience, and their knowledge and relationships would be difficult to replace. Leadership changes will occur from time to time, and we cannot predict whether significant resignations will occur or whether we will be able to recruit additional qualified personnel. Competition for senior executives and skilled personnel in the financial services and banking industry is intense, which means the cost of hiring, paying incentives and retaining skilled personnel may continue to increase. We need to continue to attract and retain key personnel and to recruit qualified individuals to succeed existing key personnel to ensure the continued growth and successful operation of our business. Our ability to effectively compete for senior executives and other qualified personnel by offering competitive compensation and benefit arrangements may increase our potential costs and may be restricted by applicable banking laws and regulations. The loss of the services of any senior executive or other key personnel, or the inability to recruit and retain qualified personnel in the future, could have a material adverse effect on our business, financial condition and results of operations.

Risks Related to Our Reputation and Operations

Our ability to maintain our reputation is critical to the success of our business, and the failure to do so may materially adversely affect our business, financial condition and results of operations.

We are a community bank, and our reputation is one of the most valuable components of our business. Threats to our reputation can come from many sources, including adverse sentiment about financial institutions generally, unethical

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practices, employee misconduct, failure to deliver minimum standards of service or quality, compliance deficiencies, and questionable or fraudulent activities of our customers. Negative publicity regarding our business, employees, or customers, with or without merit, may result in the loss of customers, investors and employees, costly litigation, a decline in revenues and increased governmental regulation and have a material adverse effect on business, financial condition and results of operations.

Our risk management framework may not be effective in mitigating risks and/or losses to us.

Our risk management framework is comprised of various processes, systems and strategies, and is designed to manage the types of risk to which we are subject, including, among others, credit, market, liquidity, interest rate and compliance. Our risk management framework may not be effective under all circumstances and may not adequately mitigate any risk or loss to us. If our risk management framework is not effective, we could suffer unexpected losses and our business, financial condition and results of operations could be materially and adversely affected. We may also be subject to potentially adverse regulatory consequences.

Interruptions, cyber-attacks, fraudulent activity or other security breaches could have a material adverse effect on our business.

In the normal course of business, we directly or through third parties collect, store, share, process and retain sensitive and confidential information regarding our customers. We devote significant resources and management focus to ensuring the integrity of our systems, against damage from fires or other natural disasters; power or telecommunications failures; acts of terrorism or wars or other catastrophic events; breaches, physical break-ins or errors resulting in interruptions and unauthorized disclosure of confidential information, through information security and business continuity programs. Notwithstanding, our facilities and systems are vulnerable to interruptions, external or internal security breaches, acts of vandalism, computer viruses, misplaced or lost data, programming or human errors, force majeure events, or other similar events.

As a bank, we are susceptible to fraudulent activity that may be committed against us or our customers, which may result in financial losses or increased costs to us or our customers, disclosure or misuse of our information or our customer's information, misappropriation of assets, privacy breaches against our customers, litigation or damage to our reputation. Such fraudulent activity may take many forms, including check fraud, electronic fraud, wire fraud, phishing, social engineering and other dishonest acts. Reported incidents of fraud and other financial crimes have increased through the U.S. We have also experienced losses due to apparent fraud and other financial crimes. Increased use of the Internet and telecommunications technologies (including mobile devices) to conduct financial and other business transactions and operations, coupled with the increased sophistication and activities of organized crime, perpetrators of fraud, hackers, terrorists and others increases our security risks. In addition to cyber-attacks or other security breaches involving the theft of sensitive and confidential information, hackers continue to engage in attacks against large financial institutions. These attacks include denial of service attacks designed to disrupt external customer facing services, and ransomware attacks designed to deny organizations access to key internal resources or systems. While we have policies and procedures designed to prevent such losses, there can be no assurance that such losses will not occur. We are not able to anticipate or implement effective preventive measures against all security breaches of these types, especially because the techniques used change frequently and because attacks can originate from a wide variety of sources. We employ detection and response mechanisms designed to contain and mitigate security incidents, but early detection may be thwarted by sophisticated attacks and malware designed to avoid detection. The payment methods that we offer are subject to potential fraud and theft by criminals, who are becoming increasingly more sophisticated, seeking to obtain unauthorized access to or exploit weaknesses that may exist in the payment systems where we may be liable for losses. Breaches of information security also may occur through intentional or unintentional acts by those having access to our systems or our customers' or counterparties' confidential information, including employees.

The access by unauthorized persons to, or the improper disclosure by us of, confidential information regarding our customers or our own proprietary information, software, methodologies and business secrets, failures or disruptions in our communications, information and technology systems, or our failure to

adequately address them, could negatively affect our customer relationship management, general ledger, deposit, loan or other systems. We cannot assure that such breaches, failures or interruptions will not occur or, if they do occur, that they will be adequately addressed by us or the third parties on which we rely. Our insurance may not fully cover all types of losses. The occurrence of any failures or

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interruptions of our communications, information and technology systems could damage our reputation, result in a loss of customer business, subject us to additional regulatory scrutiny or expose us to civil litigation and possible financial liability, any of which could have a material adverse effect on our business, financial condition or results of operations. We could be required to provide notices of security breaches. Such failures could result in increased regulatory scrutiny, legal liability, a loss of confidence in the security of our systems, our payment cards, products and services, and negative effects on our brand which could have a material adverse effect on our business, financial condition and results of operations.

Our operations could be interrupted by our third-party service providers experiencing difficulty in providing their services, terminating their services or failing to comply with banking regulations.

We depend to a significant extent on relationships with third party service providers. Specifically, we utilize third party core banking services and receive credit card and debit card services, branch capture services, Internet banking services and services complementary to our banking products from various third party service providers. These types of third party relationships are subject to increasingly demanding regulatory requirements where we must maintain and continue to enhance our due diligence and ongoing monitoring and control over our third party vendors. We may be required to renegotiate our agreements to meet these enhanced requirements, which could increase our costs. If our service providers experience difficulties or terminate their services and we are unable to replace them, our operations could be interrupted. It may be difficult for us to timely replace some of our service providers, which may be at a higher cost due to the unique services they provide. A third party provider may fail to provide the services we require, or meet contractual requirements, comply with applicable laws and regulations, or suffer a cyber-attack or other security breach. We expect that our regulators will hold us responsible for deficiencies of our third party relationships which could result in enforcement actions, including civil money penalties or other administrative or judicial penalties or fines, or customer remediation, any of which could have a material adverse effect on our business, financial condition and results of operations.

Employee misconduct could expose us to significant legal liability and reputational harm.

We are vulnerable to reputational harm because we operate in an industry in which integrity and the confidence of our customers are of critical importance. Our employees could engage in fraudulent, illegal, wrongful or suspicious activities, and/or activities resulting in consumer harm that adversely affects our customers and/or our business. The precautions we take to detect and prevent such misconduct may not always be effective and regulatory sanctions and/or penalties, serious harm to our reputation, financial condition, customer relationships and ability to attract new customers. In addition, improper use or disclosure of confidential information by our employees, even if inadvertent, could result in serious harm to our reputation, financial condition and current and future business relationships. If our internal controls against operational risks fail to prevent or detect an occurrence of such employee error or misconduct, or if any resulting loss is not insured or exceeds applicable insurance limits, it could have a material adverse effect on our business, financial condition and results of operations.

We depend on the accuracy and completeness of information provided by customers and counterparties and any misrepresented information could adversely affect our business, financial condition and results of operations.

In deciding whether to extend credit or to enter into other transactions with customers and counterparties, we may rely on information furnished to us by or on behalf of customers and counterparties, including financial statements and other financial information. Some of the information regarding customers provided to us is also used in our proprietary credit decision making and scoring models, which we use to determine whether to do business with customers and the risk profiles of such customers which are subsequently utilized by counterparties who lend us capital to fund our operations. We may also rely on representations of customers and counterparties as to the accuracy and completeness of that information. In deciding whether to extend credit, we may rely upon our customers' representations that their financial statements conform to Generally Accepted Accounting Principles ("GAAP") and present fairly, in all material respects, the financial condition, results of operations and cash flows of the customer. We also may rely on customer representations and certifications, or other audit or accountants' reports, with respect to the business

and financial condition of our customers. Whether a misrepresentation is made by the applicant, another third party or one of our employees, we generally bear the risk of loss associated with the misrepresentation. We may not detect all misrepresented information in

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our originations or from service providers we engage to assist in the approval process. Any such misrepresented information could have a material adverse effect on our business, financial condition and results of operations

Increasing scrutiny and evolving expectations from customers, regulators, investors, and other stakeholders with respect to our environmental, social and governance practices may impose additional costs on us or expose us to new or additional risks.

Companies are facing increasing scrutiny from customers, regulators, investors, and other stakeholders related to their environmental, social and governance ("ESG") practices and disclosure. Investor advocacy groups, investment funds and influential investors are also increasingly focused on these practices, especially as they relate to the environment, health and safety, diversity, labor conditions and human rights. Increased ESG-related compliance costs for us as well as among our suppliers, vendors and various other parties within our supply chain could result in increases to our overall operational costs. Failure to adapt to or comply with regulatory requirements or investor or stakeholder expectations and standards could negatively impact our reputation, ability to do business with certain partners, access to capital, and our stock price. New government regulations could also result in new or more stringent forms of ESG oversight and expanding mandatory and voluntary reporting, diligence, and disclosure.

Risks from Competition

We face strong competition from financial services companies and other companies that offer commercial banking services, which could harm our business.

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

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

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

Increased competition in our markets may result in reduced loans, deposits, and fee income, as well as reduced net interest margin and profitability. If we are unable to attract and retain banking customers and expand our loan and

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deposit growth, then we may be unable to continue to grow our business which could have a material adverse effect on our financial condition and results of operations.

We have a continuing competitive need for technological change, and we may not have the resources to effectively implement new technology or we may experience operational challenges when implementing new technology.

The financial services industry is continually undergoing rapid technological change with frequent introductions of new, technology-driven products and services. The effective use of technology increases efficiency and enables financial institutions to better serve customers and to reduce costs. Our future success depends, in part, upon our ability to address the needs of our customers by using technology to provide products and services that will satisfy customer demands, as well as to create additional efficiencies in our operations. Many of our competitors have substantially greater resources to invest in technological improvements than we do. As a result, they may be able to offer additional or superior products to those that we will be able to offer, which would put us at a competitive disadvantage. We may not be able to effectively implement new, technology-driven products and services or be successful in marketing these products and services to our customers. In addition, the implementation of technological changes and upgrades to maintain current systems and integrate new ones may also cause service interruptions, transaction processing errors and system conversion delays and may cause us to fail to comply with applicable laws. Failure to successfully keep pace with technological change affecting the financial services industry and avoid interruptions, errors and delays could have a material adverse effect on our business, financial condition and results of operations.

Risks Related to Other Business

The costs and effects of litigation, investigations or similar matters, or adverse facts and developments related thereto, could materially affect our business, financial condition and results of operations.

We are and will continue to be involved from time to time in a variety of litigation, investigations or similar matters arising out of our business. It is inherently difficult to assess the outcome of these matters, and we may not prevail in any proceedings or litigation. Any claims and lawsuits, and the disposition of such claims and lawsuits, whether through settlement, or litigation, could be time-consuming and expensive to resolve, divert management attention from executing our business plan, and lead to attempts on the part of other parties to pursue similar claims. Any claims asserted against us, regardless of merit or eventual outcome may harm our reputation. To mitigate the cost of some of these claims, we maintain insurance coverage in amounts and with deductibles that we believe are appropriate for our operations. However, our insurance coverage does not cover any civil monetary penalties or fines imposed by government authorities and may not cover all other claims that might be brought against us, including certain wage and hour class, collective and representative actions brought by customers, employees or former employees, and ponzi schemes. In addition, such insurance coverage may not continue to be available to us at a reasonable cost or at all. As a result, we may be exposed to substantial uninsured liabilities. Substantial legal liability or significant regulatory action against us could cause significant reputational harm to us and could have a material adverse impact on our business, financial condition, and results of operations.

Uncertainty relating to LIBOR calculation process and potential phasing out of LIBOR may adversely affect us.

The Financial Conduct Authority in the United Kingdom, which regulates LIBOR, will not guarantee the continuation of LIBOR on the current basis after 2021. Regulators, industry groups, and certain committees (e.g., the Alternative Reference Rates Committee) have, among other things, published recommended fallback language for LIBOR-linked financial instruments, identified recommended alternatives for certain LIBOR rates. The Federal Reserve selected a new index calculated by short-term repurchase agreements, backed by Treasury securities ("SOFR") to replace LIBOR. SOFR differs in its methodology from LIBOR in that it is a secured funding rate and calculated on a backward looking basis, and because the SOFR rate is new, the correlation with funding costs of financial institutions is uncertain. Whether or not SOFR attains market acceptance as a LIBOR replacement tool remains in question. Uncertainty as to the nature of alternative reference rates and as to potential changes or other reforms to LIBOR may adversely affect LIBOR

rates and the value of LIBOR-based loans, and to a lesser extent, securities in our portfolio, and may impact the availability and cost of hedging instruments and borrowings, including the rates we pay on our subordinated debentures. Once LIBOR rates are no longer available, we may be subject to disputes or litigation with customers and creditors over the appropriateness or

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comparability to LIBOR of the substitute indices, which could have an adverse effect on our business, financial condition and results of operations.

Our ability to access markets for funding and acquire and retain customers could be adversely affected by the deterioration of other financial institutions or the financial service industry's reputation.

Our ability to engage in routine funding transactions could be adversely affected by the actions and commercial soundness of other financial institutions. Financial services companies are interrelated as a result of trading, clearing, counterparty and other relationships. We have exposure to different industries and counterparties, and through transactions with counterparties in the financial services industry, including brokers and dealers, commercial banks, investment banks and other institutional clients. As a result, defaults by, or even rumors or questions about, one or more financial services companies, or the financial services industry generally, have led to market-wide liquidity problems and could lead to losses or defaults by us or by other institutions. These losses or defaults could have a material adverse effect on our business, financial condition and results of operations.

Severe weather, natural disasters, pandemics, acts of war or terrorism, social unrest and other external events could significantly impact our business.

Severe weather, natural disasters (including fires, earthquakes, and floods), wide spread disease or pandemics (such as COVID-19), acts of war or terrorism, social unrest and other adverse external events could have a significant impact on our ability to conduct business. Such events could affect the stability of our deposit base, impair the ability of borrowers to repay outstanding loans, impair the value of collateral securing loans, cause significant property damage, result in loss of revenue and/or cause us to incur additional expenses. The majority of our branches are located in the San Jose, San Francisco, Oakland areas, which in the past have experienced both severe earthquakes and wildfires. We do not carry earthquake insurance on our properties. Earthquakes, wildfires or other natural disasters could severely disrupt our operations. In addition, our customers and loan collateral may be severely impacted by such events, resulting in losses. Operations in our market could be disrupted by both the evacuation of large portions of the population as well as damage to and/or lack of access to our banking and operation facilities. Although management has established disaster recovery policies and procedures, the occurrence of any such events could have a material adverse effect on our business, financial condition and results of operations.

Climate change could have a material negative impact on the Company and our customers.

The Company's business, as well as the operations and activities of our clients, could be negatively impacted by climate change. Climate change presents both immediate and long-term risks to the Company and its clients, and these risks are expected to increase over time. Climate change presents multi-faceted risks, including: operational risk from the physical effects of climate events on the Company and its clients' facilities and other assets; credit risk from borrowers with significant exposure to climate risk; transition risks associated with the transition to a less carbon-dependent economy; and reputational risk from stakeholder concerns about our practices related to climate change, the Company's carbon footprint, and the Company's business relationships with clients who operate in carbon-intensive industries.

Federal and state banking regulators and supervisory authorities, investors, and other stakeholders have increasingly viewed financial institutions as important in helping to address the risks related to climate change both directly and with respect to their clients, which may result in financial institutions coming under increased pressure regarding the disclosure and management of their climate risks and related lending and investment activities. Given that climate change could impose systemic risks upon the financial sector, either via disruptions in economic activity resulting from the physical impacts of climate change or changes in policies as the economy transitions to a less carbon-intensive environment, the Company may face regulatory risk of increasing focus on the Company's resilience to climate-related risks, including in the context of stress testing for various climate stress scenarios. Ongoing legislative or regulatory uncertainties and changes

regarding climate risk management and practices may result in higher regulatory, compliance, credit, and reputational risks and costs.

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With the increased importance and focus on climate change, we are making efforts to enhance our governance of climate change-related risks and integrate climate considerations into our risk governance framework. Nonetheless, the risks associated with climate change are rapidly changing and evolving in an escalating fashion, making them difficult to assess due to limited data and other uncertainties. We could experience increased expenses resulting from strategic planning, litigation, and technology and market changes, and reputational harm as a result of negative public sentiment, regulatory scrutiny, and reduced investor and stakeholder confidence due to our response to climate change and our climate change strategy, which, in turn, could have a material negative impact on our business, results of operations, and financial condition.

Risks Related to Finance and Accounting

Accounting estimates and risk management processes rely on analytical models that may prove inaccurate resulting in a material adverse effect on our business, financial condition and results of operations.

The processes we use to estimate probable incurred loan losses and to measure the fair value of financial instruments, as well as the processes used to estimate the effects of changing interest rates and other market measures on our financial condition and results of operations, depends upon the use of analytical models. These models reflect assumptions that may not be accurate, particularly in times of market stress or other unforeseen circumstances. Even if these assumptions are adequate, the models using those assumptions may prove to be inadequate or inaccurate because of other flaws in their design or their implementation. If the models we use for interest rate risk and asset-liability management are inadequate, we may incur increased or unexpected losses upon changes in market interest rates or other market measures. If the models we use for determining our probable loan losses are inadequate, the allowance for credit losses on loans may not be sufficient to support future charge-offs. If the models we use to measure the fair value of financial instruments are inadequate, the fair value of such financial instruments may fluctuate unexpectedly or may not accurately reflect what we could realize upon sale or settlement of such financial instruments. Any such failure in our analytical models could result in losses that could have a material adverse effect on our business, financial condition and results of operations.

Changes in accounting standards could materially impact our financial statements.

From time to time, the FASB or the SEC, may change the financial accounting and reporting standards that govern the preparation of our financial statements. Such changes may result in us being subject to new or changing accounting and reporting standards. In addition, the bodies that interpret the accounting standards (such as banking regulators or outside auditors) may change their interpretations or positions on how these standards should be applied. These changes may be beyond our control, can be hard to predict and can materially impact how we record and report our financial condition and results of operations. In some cases, we could be required to apply a new or revised standard retrospectively, or apply an existing standard differently, also retrospectively, in each case resulting in our needing to revise or restate prior period financial statements. Restating or revising our financial statements may result in reputational harm or may have other adverse effects on us.

Failure to maintain effective internal controls over financial reporting could have a material adverse effect on our business and stock price.

We are required to comply with the SEC's rules implementing Section 302, Section 404, and Section 906 of the Sarbanes-Oxley Act, which will require management to certify financial and other information in our quarterly and annual reports and provide an annual management report on the effectiveness of controls over financial reporting. In particular, we are required to certify our compliance with Section 404 of the Sarbanes-Oxley Act, which requires us to furnish annually a report by management on the effectiveness of our internal control over financial reporting and our independent registered public accounting firm is required to report on the effectiveness of our internal control over financial reporting.

If we identify any material weaknesses in our internal control over financial reporting or are unable to comply with the requirements of Section 404 in a timely manner or assert that our internal control over

financial reporting is effective, or if our independent registered public accounting firm is unable to express an opinion as to the effectiveness of our internal control over financial reporting, investors, counterparties and customers may lose confidence in the accuracy and completeness of our financial statements and reports; our liquidity, access to capital markets and perceptions of our

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creditworthiness could be adversely affected; and the market price of our common stock could decline. In addition, we could become subject to investigations by the stock exchange on which our securities are listed, the SEC, the Federal Reserve, the FDIC, the DFPI or other regulatory authorities, which could require additional financial and management resources. These events could have a material adverse effect on our business and stock price.

We have significant deferred tax assets and cannot assure that it will be fully realized.

Deferred tax assets and liabilities are the expected future tax amounts for the temporary differences between the carrying amounts and tax basis of assets and liabilities computed using enacted tax rates. We regularly assess available positive and negative evidence to determine whether it is more likely than not that our net deferred tax assets will be realized. Realization of a deferred tax asset requires us to apply significant judgment and is inherently speculative because it requires estimates that cannot be made with certainty. At December 31, 2022, we had a net deferred tax asset of \$32.2 million. If we were to determine at some point in the future that we will not achieve sufficient future taxable income to realize our net deferred tax asset, we would be required, under generally accepted accounting principles, to establish a full or partial valuation allowance which would require us to incur a charge to income for the period in which the determination was made.

Risks Related to Legislative and Regulatory Developments

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

We operate in a highly regulated environment and are subject to supervision and regulation by a number of governmental regulatory agencies, including the Federal Reserve, the DFPI and the FDIC. Regulations adopted by these agencies, which are generally intended to provide protection for depositors and customers rather than for the benefit of shareholders, govern a comprehensive range of matters relating to ownership and control of our shares, our acquisition of other companies and businesses, permissible activities for us to engage in, maintenance of adequate capital levels, and other aspects of our operations. These bank regulators possess broad authority to prevent or remedy unsafe or unsound practices or violations of law. The laws and regulations applicable to the banking industry could change at any time and we cannot predict the effects of these changes on our business, profitability or growth strategy. Increased regulation could increase our cost of compliance and adversely affect profitability. Moreover, certain of these regulations contain significant punitive sanctions for violations, including monetary penalties and limitations on a bank's ability to implement components of its business plan, such as expansion through mergers and acquisitions or the opening of new branch offices. In addition, changes in regulatory requirements can significantly affect the services that we provide as well as the costs associated with compliance efforts. Furthermore, government policy and regulation, particularly as implemented through the Federal Reserve System, significantly affect credit conditions. Negative developments in the financial industry and the impact of new legislation and regulation in response to those developments could negatively impact our business operations and adversely impact our financial performance. In addition, adverse publicity and damage to our reputation arising from the failure or perceived failure to comply with legal, regulatory or contractual requirements could affect our ability to attract and retain customers.

Legislative and regulatory actions taken now or in the future may impact our business, governance structure, financial condition or results of operations. Proposed legislative and regulatory actions, including changes to financial regulation and the corporate tax law, may not occur on the timeframe that is expected, or at all, which could result in additional uncertainty for our business.

New proposals for legislation continue to be introduced in the U.S. Congress that could substantially increase regulation of the financial services industry, impose restrictions on the operations and general ability of firms within the industry to conduct business consistent with historical practices, including in the areas of compensation, interest rates, financial product offerings and disclosures, and have an effect on bankruptcy proceedings with respect to consumer residential real estate mortgages, among other things. Federal and state regulatory agencies also frequently adopt changes to their regulations or change the manner in which existing

regulations are applied. Presently, in addition to refining existing regulations implemented after the 2008-2010 financial crisis, the banking regulators are also focusing their attention on certain policy areas, such as climate risk, digital currencies, and technological innovation. This new focus

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may require us to invest significant management attention and resources to evaluate and make any changes required by the legislation and accompanying rules.

Certain aspects of current or proposed regulatory or legislative changes, including to laws applicable to the financial industry, if enacted or adopted, may impact the profitability of our business activities, require more oversight or change certain of our business practices, including the ability to offer new products, obtain financing, attract deposits, make loans and achieve satisfactory interest spreads, and could expose us to additional costs, including increased compliance costs. These changes also may require us to invest significant management attention and resources to make any necessary changes to operations to comply and could have a material adverse effect on our business, financial condition and results of operations. In addition, any proposed legislative or regulatory changes, including those that could benefit our business, financial condition and results of operations, may not occur on the timeframe that is proposed, or at all, which could result in additional uncertainty for our business.

Federal and state regulators periodically examine our business, and we may be required to remediate adverse examination findings.

The Federal Reserve and the DFPI periodically examine our business, including our compliance with laws and regulations. If, as a result of an examination, a banking agency were to determine that our financial condition, capital resources, asset quality, earnings prospects, management, liquidity or other aspects of any of our operations had become unsatisfactory, or that we were in violation of any law or regulation, they may take a number of different remedial actions as they deem appropriate. These actions include the power to enjoin “unsafe or unsound” practices, to require affirmative action to correct any conditions resulting from any violation or practice, to issue an administrative order that can be judicially enforced, to direct an increase in our capital, to restrict our growth, to assess civil money penalties, to fine or remove officers and directors and, if it is concluded that such conditions cannot be corrected or there is an imminent risk of loss to depositors, to terminate our deposit insurance and place us into receivership or conservatorship. Any regulatory action against us could have an adverse effect on our business, financial condition and results of operations.

We face a risk of noncompliance and enforcement action with the Bank Secrecy Act and other anti-money laundering statutes and regulations.

The Bank Secrecy Act, the USA Patriot Act and other laws and regulations require financial institutions, among other duties, to institute and maintain an effective anti-money laundering program and to file reports such as suspicious activity reports and currency transaction reports. We are required to comply with these and other anti-money laundering requirements. The federal banking agencies and Financial Crimes Enforcement Network are authorized to impose significant civil money penalties for violations of those requirements and have recently engaged in coordinated enforcement efforts against banks and other financial services providers with the U.S. Department of Justice, Drug Enforcement Administration and Internal Revenue Service. We are also subject to increased scrutiny of compliance with the rules enforced by the Office of Foreign Assets Control. If our policies, procedures and systems are deemed deficient, we would be subject to liability, including fines and regulatory actions, which may include restrictions on our ability to pay dividends and the necessity to obtain regulatory approvals to proceed with certain aspects of our business plan, including our acquisition plans. Failure to maintain and implement adequate programs to combat money laundering and terrorist financing could also have serious reputational consequences for us. Any of these results could have a material adverse effect on our business, financial condition and results of operations.

We are subject to numerous laws designed to protect consumers, including the Community Reinvestment Act and fair lending laws, and failure to comply with these laws could lead to a wide variety of sanctions.

The Community Reinvestment Act, the Equal Credit Opportunity Act, the Fair Housing Act and other fair lending laws and regulations impose non-discriminatory lending and other requirements on financial institutions. The U.S. Department of Justice and other federal agencies, including the FDIC and the CFPB, are responsible for enforcing these laws and regulations. A successful challenge to an institution’s performance under the Community Reinvestment Act, fair lending and other compliance laws and regulations could result in a wide variety of sanctions, including the required payment of damages and civil money penalties,

injunctive relief, imposition of restrictions on mergers and acquisitions activity and restrictions on expansion. Private parties may also have the ability to challenge an institution's performance under fair lending laws in private class action litigation. The costs of defending, and any adverse outcome from, any such

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challenge could damage our reputation or could have a material adverse effect on our business, financial condition and results of operations.

Regulations relating to privacy, information security and data protection could increase our costs, affect or limit how we collect and use personal information.

We are subject to various privacy, information security and data protection laws, including requirements concerning security breach notification, and we could be negatively impacted by these laws. For example, our business is subject to the Gramm-Leach-Bliley Act of 1999 which, among other things: (i) imposes certain limitations on our ability to share nonpublic personal information about our customers with nonaffiliated third parties; (ii) requires that we provide certain disclosures to customers about our information collection, sharing and security practices and afford customers the right to “opt out” of any information sharing by us with nonaffiliated third parties (with certain exceptions); and (iii) requires that we develop, implement and maintain a written comprehensive information security program containing safeguards appropriate based on our size and complexity, the nature and scope of our activities, and the sensitivity of customer information we process, as well as plans for responding to data security breaches. Various state and federal banking regulators and states have also enacted data security breach notification requirements with varying levels of individual, consumer, regulatory or law enforcement notification in certain circumstances in the event of a security breach. Moreover, legislators and regulators in the United States are increasingly adopting or revising privacy, information security and data protection laws that potentially could have a significant impact on our current and planned privacy, data protection and information security-related practices, our collection, use, sharing, retention and safeguarding of consumer or employee information.

Compliance with current or future privacy, data protection and information security laws (including those regarding security breach notification) affecting customer or employee data to which we are subject could result in higher compliance and technology costs and could restrict our ability to provide certain products and services, which could have a material adverse effect on our business, financial condition and results of operations. Our failure to comply with privacy, data protection and information security laws could result in potentially significant regulatory or governmental investigations or actions, litigation, fines, sanctions and damage to our reputation, which could have a material adverse effect on our business, financial condition and results of operations.

Risks Related to Our Common Stock

An investment in our common stock is not an insured deposit.

An investment in our common stock is not a bank deposit and, therefore, is not insured against loss by the FDIC, any other deposit insurance fund or by any other public or private entity. Investment in our common stock is inherently risky for the reasons described herein, and is subject to the same market forces that affect the price of common stock in any company. As a result, if you acquire our common stock, you could lose some or all of your investment.

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

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

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

adversely affect the market price of our common stock some of which are out of our control. Among the factors that could affect our stock price are:

- changes in business and economic condition;

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- actual or anticipated quarterly fluctuations in our operating results and financial condition;
- actual occurrence of one or more of the risk factors outlined above;
- recommendations by securities analysts or failure to meet, securities analysts' estimates of our financial and operating performance, or lack of research reports by industry analysts or ceasing of coverage;
- speculation in the press or investment community generally or relating to our reputation, our operations, our market area, our competitors or the financial services industry in general;
- strategic actions by us or our competitors, such as acquisitions, restructurings, dispositions or financings;
- actions by institutional investors;
- fluctuations in the stock price and operating results of our competitors;
- future sales of our equity, equity related or debt securities;
- proposed or adopted regulatory changes or developments;
- anticipated or pending investigations, proceedings, or litigation that involve or affect us;
- the level and extent to which we do or are allowed to pay dividends;
- trading activities in our common stock, including short selling;
- deletion from well-known index or indices;
- domestic and international economic factors unrelated to our performance; and
- general market conditions and, in particular, developments related to market conditions for the financial services industry.

The trading volume in our common stock is less than that of other larger financial services companies.

Although our common stock is listed for trading on the Nasdaq, its trading volume is less than that of other, larger financial services companies, and investors are not assured that a liquid market will exist at any given time for our common stock. A public trading market having the desired characteristics of depth, liquidity and orderliness depends on the presence in the marketplace at any given time of willing buyers and sellers of our common stock. This presence depends on the individual decisions of investors and general economic and market conditions over which we have no control. Given the lower trading volume of our common stock, significant sales of our common stock, or the expectation of these sales, could cause our stock price to fall.

Our dividend policy may change without notice, and our future ability to pay dividends is subject to restrictions.

Historically, our board of directors has declared quarterly dividends on our common stock. However, we have no obligation to continue doing so and may change our dividend policy at any time without notice to holders of our common stock. Holders of our common stock are only entitled to receive such cash dividends as our board of directors, in its discretion, may declare out of funds legally available for such payments. Furthermore, consistent with our strategic plans, growth initiatives, capital availability, projected liquidity needs, and other factors, we have made, and will continue to make, capital management decisions and policies that could adversely impact the amount of dividends paid to holders of our common stock.

HCC is a separate and distinct legal entity from HBC. We receive substantially all of our revenue from dividends paid to us by HBC, which we use as the principal source of funds to pay our expenses and to pay dividends to our shareholders, if any. Various federal and/or state laws and regulations limit the amount of dividends that HBC may pay us. If the HBC does not receive regulatory approval or does not maintain a level of capital sufficient to permit it to make dividend payments to us while maintaining adequate capital levels, our ability to pay our expenses and our business, financial condition and results of operations could be materially adversely impacted.

As a bank holding company, we are subject to regulation by the Federal Reserve. The Federal Reserve has indicated that bank holding companies should carefully review their dividend policy in relation to the organization's overall asset quality, current and prospective earnings and level, composition and quality of capital. The guidance provides that we inform and consult with the Federal Reserve prior to declaring and paying a dividend that exceeds earnings for the period for which the dividend is being paid or that could result in an adverse change to our capital structure, including interest on our debt obligations. If required payments

on our debt obligations are not made or are deferred, or dividends on any preferred stock we may issue are not paid, we will be prohibited from paying dividends on our common stock.

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The Capital Rules also introduced a new capital conservation buffer on top of the minimum risk-based capital ratios. Failure to maintain a capital conservation buffer above certain levels will result in restrictions on the Company's ability to make dividend payments, redemptions or other capital distributions. These requirements, and any other new regulations or capital distribution constraints, could adversely affect the ability of the Company to pay dividends to HCC and, in turn, affect our ability to pay dividends on our common stock.

We have limited the circumstances in which our directors will be liable for monetary damages.

We have included in our articles of incorporation a provision to eliminate the liability of directors for monetary damages to the maximum extent permitted by California law. The effect of this provision will be to reduce the situations in which we or our shareholders will be able to seek monetary damages from our directors.

Our bylaws also have a provision providing for indemnification of our directors and executive officers and advancement of litigation expenses to the fullest extent permitted or required by California law, including circumstances in which indemnification is otherwise discretionary. Also, we have entered into agreements with our officers and directors in which we similarly agreed to provide indemnification that is otherwise discretionary. Such indemnification may be available for liabilities arising in connection with future offerings.

Future equity issuances could result in dilution, which could cause our common stock price to decline.

We are generally not restricted from issuing additional shares of our common stock, up to the 100 million shares of voting common stock and 10 million shares of preferred stock authorized in our articles of incorporation (subject to Nasdaq shareholder approval rules), which in each case could be increased by a vote of a majority of our shares. We may issue additional shares of our common stock in the future pursuant to current or future equity compensation plans, upon conversions of preferred stock or debt, upon exercise of warrants or in connection with future acquisitions or financings. If we choose to raise capital by selling shares of our common stock for any reason, the issuance would have a dilutive effect on the holders of our common stock and could have a material negative effect on the market price of our common stock.

We may issue shares of preferred stock in the future, which could make it difficult for another company to acquire us or could otherwise adversely affect holders of our common stock, which could depress the price of our common stock.

Although there are currently no shares of our preferred stock issued and outstanding, our articles of incorporation authorize us to issue up to 10 million shares of one or more series of preferred stock. The board also has the power, without shareholder approval (subject to Nasdaq shareholder approval rules), to set the terms of any series of preferred stock that may be issued, including voting rights, dividend rights, preferences over our common stock with respect to dividends or in the event of a dissolution, liquidation or winding up and other terms. In the event that we issue preferred stock in the future that has preference over our common stock with respect to payment of dividends or upon our liquidation, dissolution or winding up, or if we issue preferred stock with voting rights that dilute the voting power of our common stock, the rights of the holders of our common stock or the market price of our common stock could be adversely affected. In addition, the ability of our board of directors to issue shares of preferred stock without any action on the part of our shareholders may impede a takeover of us and prevent a transaction perceived to be favorable to our shareholders.

The holders of our debt obligations will have priority over our common stock with respect to payment in the event of liquidation, dissolution or winding up and with respect to the payment of interest and dividends.

The holders of our debt obligations will have priority over our common stock with respect to payment in the event of liquidation, dissolution or winding up and with respect to the payment of interest and dividends.

In any liquidation, dissolution or winding up of the Company, our common stock would rank below all claims of the holders of outstanding debt issued by the Company. As of December 31, 2022, we had \$40.0 million principal amount of subordinated notes outstanding due May 15, 2032. In such event, holders of our common stock would not be entitled to receive any payment or other distribution of assets upon the liquidation, dissolution or winding up of the Company until after all of the Company's obligations to the debt holders were satisfied and holders of the subordinated debt had received

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any payment or distribution due to them. In addition, we are required to pay interest on the subordinated notes and if we are in default in the payment of interest we would not be able to pay any dividends on our common stock.

Provisions in our charter documents and California law may have an anti-takeover effect, and there are substantial regulatory limitations on changes of control of bank holding companies.

Our articles of incorporation and bylaws contain a number of provisions relating to corporate governance and rights of shareholders that might discourage future takeover attempts. As a result, shareholders who might desire to participate in such transactions may not have an opportunity to do so. In addition, these provisions will also render the removal of our board of directors or management more difficult. Such provisions include a requirement that shareholder approval for any action proposed by the Company must be obtained at a shareholders meeting and may not be obtained by written consent. Our bylaws provide that shareholders seeking to make nominations of candidates for election as directors, or to bring other business before an annual meeting of the shareholders, must provide timely notice of their intent in writing and follow specific procedural steps in order for nominees or shareholder proposals to be brought before an annual meeting.

Provisions of our charter documents and the California General Corporation Law, or the CGCL, could make it more difficult for a third party to acquire us, even if doing so would be perceived to be beneficial by our shareholders. Furthermore, with certain limited exceptions, federal regulations prohibit a person or company or a group of persons deemed to be “acting in concert” from, directly or indirectly, acquiring more than 10% (5% if the acquirer is a bank holding company) of any class of our voting stock or obtaining the ability to control in any manner the election of a majority of our directors or otherwise direct the management or policies of our company without prior notice or application to and the approval of the Federal Reserve. Under the California Financial Code, no person may, directly or indirectly, acquire control of a California state bank or its holding company unless the DFPI has approved such acquisition of control. A person would be deemed to have acquired control of HBC if such person, directly or indirectly, has the power (i) to vote 25% or more of the voting power of HBC or (ii) to direct or cause the direction of the management and policies of HBC. For purposes of this law, a person who directly or indirectly owns or controls 10% or more of our outstanding common stock would be presumed to control HBC. Accordingly, prospective investors need to be aware of and comply with these requirements, if applicable, in connection with any purchase of shares of our common stock. Moreover, the combination of these provisions effectively inhibits certain mergers or other business combinations, which, in turn, could adversely affect the market price of our common stock.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

The main and executive offices of Heritage Commerce Corp and Heritage Bank of Commerce are located at 224 Airport Parkway in San Jose, California 95110, with branch offices located at 15575 Los Gatos Boulevard in Los Gatos, California 95032, at 3137 Stevenson Boulevard in Fremont, California 94538, at 387 Diablo Road in Danville, California 94526, at 300 Main Street in Pleasanton, California 94566, at 1990 N. California Boulevard in Walnut Creek, California 94596, at 1987 First Street in Livermore, California 94550, at 18625 Sutter Boulevard in Morgan Hill, California 95037, at 7598 Monterey Street in Gilroy, California 95020, at 351 Tres Pinos Road in Hollister, California 95023, at 419 S. San Antonio Road in Los Altos, California 94022, at 333 W. El Camino Real in Sunnyvale, California 94087, at 325 Lytton Avenue in Palo Alto, California 94301, at 400 S. El Camino Real in San Mateo, California, 94402, at 2400 Broadway in Redwood City, California 94063, at 120 Kearny Street in San Francisco, California 94108, at 999 5th Avenue in San Rafael, California 94901 and at 1111 Broadway in Oakland, California 94607. Bay View Funding's administrative offices are located at 224 Airport Parkway, San Jose, California 95110.

Main Offices

The main office of HBC, the San Jose branch office of HBC and the Bay View Funding administrative office are located at 224 Airport Parkway in San Jose, consisting of approximately 54,910 square feet in a six-story Class-A type office building, which are subject to a direct lease dated June 27, 2019, which expires on July 31, 2030. The current

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monthly rent payment is \$216,006, subject to 3% annual increases. The Company has reserved the right to extend the term of the lease for one additional period of five years.

Branch Offices

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

In March of 2018, the Company extended its lease for approximately 3,022 square feet on the first floor of a three-story multi-tenant office building located at 333 West El Camino Real in Sunnyvale, California. The current monthly rent payment is \$18,805, subject to annual increases of 3% until the lease expires on May 31, 2023. The Company has announced that it is closing the Sunnyvale branch office on April 28, 2023.

In November of 2018, the Company extended its lease for approximately 1,920 square feet in a one-story stand-alone building located in an office complex at 15575 Los Gatos Boulevard in Los Gatos, California. The current monthly rent payment is \$7,563, subject to annual increases of 3% until the lease expires on November 30, 2023. The Company has reserved the right to extend the term of the lease for one additional period of five years.

In May of 2019, the Company amended its lease for approximately 4,096 square feet in a one-story stand-alone office building located at 300 Main Street in Pleasanton, California. The current monthly rent payment is \$22,374, subject to 3% annual increases until the lease expires on April 30, 2026. The Company has reserved the right to extend the term of the lease for two additional periods of five years.

In June of 2019, the Company extended its lease for an additional five years for approximately 3,391 square feet in a two-story multi-tenant commercial center located at 351 Tres Pinos in Hollister, California. The current monthly rent payment is \$5,213, subject to 3% annual increases until the lease expires on June 30, 2024.

In August of 2019, the Company extended its lease for approximately 3,772 square feet on the first and second floors in a two-story multi-tenant multi-use building located at 1987 First Street in Livermore, California. The current monthly rent payment is \$9,045, until the lease expires on September 30, 2024. The Company has reserved the right to extend the term of the lease for one additional period of five years.

In October of 2019, as part of the acquisition of Presidio Bank, the Company assumed a lease for approximately 4,154 square feet on the first floor in a multi-tenant office building located at 325 Lytton Avenue in Palo Alto, California. The current monthly rent payment is \$40,966, subject to annual increases of 3% until the lease expires on January 31, 2025. The Company has reserved the right to extend the lease for one additional period of five years.

In October of 2019, also as part of the acquisition of Presidio Bank, the Company assumed a lease for approximately 7,029 square feet on the first floor in a multi-tenant office building located at 1990 N. California Boulevard in Walnut Creek, California. The current monthly rent payment is \$29,733, subject to annual increases of 3% until the lease expires December 31, 2027. The Company has reserved the right to extend the lease for one additional period of five years.

In October of 2019, also as part of the acquisition of Presidio Bank, the Company assumed a lease for approximately 3,063 square feet on the first floor in a multi-tenant office building located at 400 S. Camino Real in San Mateo, California expiring on October 31, 2024. In January 2020, The Company amended the lease expiration date to October 31, 2030 and executed a new lease for an additional space on the tenth floor for approximately 5,023 square feet. The current monthly rent payment for the combined space of approximately 8,086 square feet is \$59,928, subject to annual increases of 3% until the lease expires October 31, 2030. The Company has reserved the right to extend the lease for two additional period of five years.

In February 2020, the Company extended its lease for approximately 3,172 square feet in a one-story multi-tenant multi-use building located at 3137 Stevenson Boulevard in Fremont, California. The current monthly rent payment is \$10,432, subject to annual increases of 3% until the lease expires on February 29, 2024. The Company has reserved the right to extend the term of the lease for one additional period of three years.

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In January of 2021, the Company amended and extended its lease for approximately 6,233 square feet on the twenty third floor in a multi-tenant office building located at 120 Kearny Street in San Francisco, California. The current monthly rent payment is \$45,475, subject to annual increases of 3% until the lease expires on March 31, 2026. The Company has reserved the right to extend the term of the lease for one additional period or five years.

In May of 2021, the Company extended its lease for approximately 4,716 square feet in a one-story multi-tenant office building located at 18625 Sutter Boulevard in Morgan Hill, California. The current monthly rent payment is \$6,013, subject to annual increases of 2% until the lease expires on October 31, 2026. The Company has reserved the right to extend the term of the lease for one additional period of five years.

In May of 2021, the Company extended its lease for approximately 2,505 square feet on the first floor in a three-story multi-tenant multi-use building located at 7598 Monterey Street in Gilroy, California. The current monthly rent payment is \$6,104 until the lease expires on September 30, 2023. The Company has reserved the right to extend the term of the lease for one additional period of two years.

In December of 2021, the Company entered into a new lease agreement for approximately 4,099 square feet on the sixteenth floor in a multi-tenant office building located at 1111 Broadway in Oakland, CA. The current monthly rent payment is \$23,569, subject to annual increases of 3% until the lease expires on June 30, 2029. The Company has reserved the right to extend the term of the lease for one additional period of five years.

In April of 2022, the Company extended its lease for approximately 2,369 square feet on the first floor of a two-story multi-tenant multi-use building located at 2400 Broadway in Redwood City, California. The current monthly rent payment is \$14,398 until the lease expires on October 31, 2024.

In August of 2022, the Company extended its lease for approximately 4,188 square feet on the first floor in a multi-tenant office building located at 999 5th Avenue in San Rafael, California. The current monthly rent payment is \$17,704, subject to annual increases of 3% until the lease expires on December 31, 2027. The Company has reserved the right to extend the lease for one additional period of five years.

In January of 2023, the Company extended its lease for approximately 5,213 square feet on the first floor in a two-story multi-tenant office building located at 419 S. San Antonio Road in Los Altos, California. The current monthly rent payment is \$31,968, subject to annual increases of 3% until the lease expires on April 30, 2030. The Company has reserved the right to extend the term of the lease for one additional period of five years.

Bay View Funding Office

The Bay View Funding administrative office is located at 224 Airport Parkway in San Jose, California, consisting of approximately 7,849 square feet and is subject to a sublease with Heritage Bank of Commerce dated March 6, 2020. The current monthly rent payment is \$29,968, which is included in the main office of HBC's total rent of \$216,006, subject to 3% annual increases until the sublease expires July 31, 2030.

For additional information on operating leases and rent expense, refer to Note 7 to the Consolidated Financial Statements following "Item 15 — *Exhibits and Financial Statement Schedules*."

ITEM 3. *LEGAL PROCEEDINGS*

We evaluate all claims and lawsuits with respect to their potential merits, our potential defenses and counterclaims, settlement or litigation potential and the expected effect on us. The outcome of any claims or litigation, regardless of the merits, is inherently uncertain. Any claims and other lawsuits, and the disposition of such claims and lawsuits, whether through settlement or litigation, could be time-consuming and expensive to resolve, divert our attention from executing our business plan, result in efforts to enjoin our activities, and lead to attempts by third parties to seek similar claims.

For more information regarding legal proceedings, see Note 15 “Commitments and Contingencies” to the consolidated financial statements.

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ITEM 4. MINE SAFETY DISCLOSURES

Not Applicable.

PART II

ITEM 5. MARKET FOR THE REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Market Information

The Company's common stock is listed on the NASDAQ Global Select Market under the symbol "HTBK."

The closing price of our common stock on February 9, 2023 was \$12.17 per share as reported by the NASDAQ Global Select Market.

As of February 9, 2023, there were approximately 808 holders of record of common stock. There are no other classes of common equity outstanding.

Dividend Policy

The amount of future dividends will depend upon our earnings, financial condition, capital requirements and other factors, and will be determined by our Board of Directors on a quarterly basis. It is Federal Reserve policy that bank holding companies generally pay dividends on common stock only out of income available over the past year, and only if prospective earnings retention is consistent with the organization's expected future needs and financial condition. It is also Federal Reserve policy that bank holding companies not maintain dividend levels that undermine the holding company's ability to be a source of strength to its banking subsidiaries. Additionally, in consideration of the current financial and economic environment, the Federal Reserve has indicated that bank holding companies should carefully review their dividend policy and has discouraged payment ratios that are at maximum allowable levels unless both asset quality and capital are very strong. Under the federal Prompt Corrective Action regulations, the Federal Reserve or the FDIC may prohibit a bank holding company from paying any dividends if the holding company's bank subsidiary is classified as undercapitalized.

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

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

For information on the statutory and regulatory limitations on the ability of the Company to pay dividends and on HBC to pay dividends to HCC see "*Item 1 — Business — Supervision and Regulation — Heritage Commerce Corp – Dividend Payments, Stock Redemptions, and Repurchases and – Heritage Bank of Commerce – Dividend Payments.*"

Performance Graph

The following graph compares the stock performance of the Company from December 31, 2017 to December 31, 2022, to the performance of several specific industry indices. The performance of the S&P 500 Index, NASDAQ Stock Index and NASDAQ Bank Stocks were used as comparisons to the Company's stock

performance. Management believes that a performance comparison to these indices provides meaningful information and has therefore included those comparisons in the following graph.

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Graphic

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The following chart compares the stock performance of the Company from December 31, 2017 to December 31, 2022, to the performance of several specific industry indices. The performance of the S&P 500 Index, NASDAQ Stock Index and NASDAQ Bank Stocks were used as comparisons to the Company's stock performance.

Index	Period Ending					
	12/31/17	12/31/18	12/31/19	12/31/20	12/31/21	12/31/22
Heritage Commerce Corp *	100	74	84	58	78	85
S&P 500 *	100	94	121	140	178	144
NASDAQ - Total US*	100	96	130	187	227	152
NASDAQ Bank Index*	100	82	100	89	124	101

* Source: S&P Global — (434) 977-1600

ITEM 6. [RESERVED]

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

The following discussion provides information about the results of operations, financial condition, liquidity, and capital resources of Heritage Commerce Corp (the “Company” or “HCC”), its wholly-owned subsidiary, Heritage Bank of Commerce (the “Bank” or “HBC”), and HBC’s wholly-owned subsidiary, CSNK Working Capital Finance Corp, a California Corporation, dba Bay View Funding. This information is intended to facilitate the understanding and assessment of significant changes and trends related to our financial condition and the results of operations. This discussion and analysis should be read in conjunction with our consolidated financial statements and the accompanying notes presented elsewhere in this report. Unless we state otherwise or the context indicates otherwise, references to the “Company,” “Heritage,” “we,” “us,” and “our,” in this Report on Form 10-K refer to Heritage Commerce Corp and its subsidiaries.

The Company completed its acquisition of Bay View Funding on November 1, 2014. The Company completed its merger with Focus Business Bank (“Focus”) on August 20, 2015. The Company completed its merger with Tri-Valley Bank (“Tri-Valley”) on April 6, 2018, and the Company completed its merger with United American Bank (“United American”) on May 4, 2018. The Company completed its merger with Presidio Bank (“Presidio”) on October 11, 2019. These mergers are discussed in more detail below, and in Notes 1 and 8 to the consolidated financial statements.

Critical Accounting Policies and Estimates

The preparation of financial statements in accordance with the accounting principles generally accepted in the United States (“U.S. GAAP”) requires management to make a number of judgments, estimates and assumptions that affect the reported amount of assets, liabilities, income and expense in the financial statements. Various elements of our accounting policies, by their nature, involve the application of highly sensitive and judgmental estimates and assumptions. Some of these policies and estimates relate to matters that are highly complex and contain inherent uncertainties. It is possible that, in some instances, different estimates and assumptions could reasonably have been made and used by management, instead of those we applied, which might have produced different results that could have had a material effect on the financial statements.

Our most significant accounting policies are described in Note 1 — *Summary of Significant Accounting Policies* in the consolidated financial statements included in this Form 10-K. Certain of these accounting policies require management to use significant judgment and estimates, which can have a material impact on the carrying value of certain assets and liabilities, and we consider these policies to be our critical accounting estimates. The judgment and assumptions made are based upon historical experience, future forecasts, or other factors that management believes to be reasonable under the circumstances. Because of the nature of the judgment and assumptions, actual results could differ from estimates, which could have a material effect on our financial condition and results of operations. The following accounting policies materially affect our reported earnings and financial condition and require significant judgments and estimates. Management has reviewed these critical accounting estimates and related disclosures with our Board of Directors’ Audit Committee.

Allowance for Credit Losses on Loans (“ACLL”)

On January 1, 2020, the Company adopted the current expected credit loss (“CECL”) model under Accounting Standards Update (“ASU”) 2016-13 (Topic 326) using the modified retrospective approach. See Note 4 – *Loans and Allowance for Credit Losses on Loans* to the consolidated financial statements and the “*Allowance for Credit Losses on Loans*” section for more information on the ACLL.

The allowance for credit losses on loans represents management’s estimate of all expected credit losses over the expected contractual life of the loan portfolio. The ACLL is a valuation amount that is deducted from the amortized cost basis of loans, and is adjusted each period by an expense or credit for credit losses, which is recognized in earnings, and reduced by loan charge-offs, net of recoveries. Determining the appropriateness of the ACLL is complex and requires judgement by management about inherently uncertain factors.

Management utilizes a discounted cash flow methodology to estimate the ACLL. Expected cash flows are estimated for each loan and discounted using the contractual terms of the loan, calculated probabilities of default, loss

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given default, prepayment and curtailment estimates as well as qualitative factors. The probability of default estimates are generated using a regression models used to estimate the likelihood of a loan being charged-off within the life of the loan. The regression model uses combinations of variables to assess historical loss correlations to economic factors and these variables become model forecast inputs for economic factors that are updated in the model each period. The Bank uses an economic forecast provided by a third-party for these model inputs. These economic factors included variables such as California state gross product, California unemployment rate, California home price index, and a commercial real estate value index. Qualitative factors are also applied by management to reflect increased portfolio risks from such factors as collateral value risk, portfolio growth, or loan grade and performance trends that management has assessed as not being fully captured in the quantitative estimate.

The ACLL represents management's best estimate of potential loan losses, but significant changes in prevailing economic conditions could result in material changes in the allowance. Generally, an improving economic forecast generates a lower ACLL estimate than a weakening economic forecast. One of the most significant judgments used in estimating the ACLL is the reasonable and supportable macroeconomic forecast for the economic factors used in the model. Changes in the macroeconomic forecast, especially for California state gross product and the California unemployment rate, could significantly impact the calculated estimated credit loss. The economic forecast utilized for the ACLL model input is inherently uncertain and many external factors could impact these forecasts. Management reviews the forecast inputs to ensure they are reasonable and supportable, however, changes in local and national economic conditions will impact the allowance level and an increase in the California unemployment rate specifically would have the largest impact on the allowance level. While management utilizes its best judgement and current information available, the adequacy of the ACLL is significantly determined by certain factors outside the Company's control, such as the performance of our loan portfolio, changes in the economic environment including economic uncertainty, changes in interest rates, and any regulatory changes. Additionally, the level of ACLL may fluctuate based on the balance and mix of the loan portfolio.

Qualitative factors are evaluated each period and applied in instances when management assesses that additional risks not captured in the quantitative estimate should be factored into the overall ACLL estimate.

These risks include loan performance trends, collateral value risk and portfolio growth characteristics. Changes in the assessment of these qualitative factors could significantly impact the calculated estimated credit loss.

Other key assumptions in the calculation of the ACLL include the forecast and reversion to mean time periods for the economic factor inputs, and prepayment and curtailment assumptions. The model calculation is less sensitive to these assumptions than to the macroeconomic forecast and the application of qualitative factors.

Executive Summary

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

The primary activity of the Company is commercial banking. The Company's operations are located in the general San Francisco Bay Area of California in the counties of Alameda, Contra Costa, Marin, San Benito, San Francisco, San Mateo, and Santa Clara. The Company's market includes the cities of Oakland, San Francisco and San Jose and the headquarters of a number of technology based companies in the region known commonly as Silicon Valley. The Company's customers are primarily closely held businesses and professionals.

Performance Overview

For the year ended December 31, 2022, net income was \$66.6 million, or \$1.09 per average diluted common share, compared to \$47.7 million, or \$0.79 per average diluted common share, for the year ended December 31, 2021, and \$35.3 million, or \$0.59 per average diluted common share for the year ended December 31, 2020. The Company's annualized return on average tangible assets was 1.27% and annualized return on average tangible common equity was 15.57% for the year ended December 31, 2022, compared to 0.96% and 11.86%, respectively, for the year ended December 31, 2021, and 0.83% and 9.04%, respectively, for the year ended December 31, 2020.

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Factoring Activities - Bay View Funding

	December 31, 2022	December 31, 2021
	(Dollars in thousands)	
Total factored receivables at period-end	\$ 79,263	\$ 53,229
Average factored receivables:		
For the year ended	\$ 64,099	\$ 52,618
Total full time equivalent employees at period-end	28	31

2022 Highlights

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

- Net interest income increased 23% to \$179.9 million for the year ended December 31, 2022, compared to \$146.1 million for the year ended December 31, 2021. For the year ended December 31, 2022, the FTE net interest margin increased 52 basis points to 3.57%, compared to 3.05% for the year ended December 31, 2021, primarily due to higher average balances of loans and investment securities, higher average yields on investment securities and overnight funds, partially offset by lower interest and fees on Small Business Administration ("SBA") Paycheck Protection Program ("PPP") loans, a decrease in the accretion of the loan purchase discount into interest income from acquired loans, lower prepayment fees, a lower yield on the Bay View Funding factoring portfolio, and a higher cost of funds.
- The average yield on the total loan portfolio decreased to 4.91% for the year ended December 31, 2022, compared to 5.03% for the year ended December 31, 2021, primarily due to a decrease in interest and fees on PPP loans, a decrease in the accretion of the loan purchase discount into interest income from acquired loans, lower prepayment fees, and an increase in the average balance of lower yielding purchased residential mortgages.
- In aggregate, the remaining net purchase discount on total loans acquired was \$4.6 million at December 31, 2022.
- The average cost of deposits was 0.15% for the year ended December 31, 2022, compared to 0.11% for the year ended December 31, 2021.
- There was a \$766,000 provision for credit losses on loans for the year ended December 31, 2022, compared to a \$3.1 million negative provision for credit losses on loans for the year ended December 31, 2021.
- For the year ended December 31, 2022, total noninterest income increased 4% to \$10.1 million, compared to \$9.7 million for the year ended December 31, 2021, primarily due to higher income on off-balance sheet deposits, and a \$669,000 gain on warrants, partially offset by a lower gain on sale of SBA loans and a lower gain on proceeds from company-owned life insurance during the year ended December 31, 2022.
- Noninterest expense for the year ended December 31, 2022 increased to \$94.9 million, compared to \$93.1 million for the year ended December 31, 2021, primarily due to higher salaries and employee benefits, higher rent included in occupancy and equipment expense, and higher insurance and information technology related expenses during the year ended December 31, 2022. These increases during 2022 were partially offset by higher legal fees included in professional fees and a reserve for a legal settlement included in other noninterest expense during the year ended December 31, 2021.

- The efficiency ratio for the year ended December 31, 2022 improved to 44.93%, compared to 59.74% for the year ended December 31, 2021, primarily due to an increase in net interest income from the rising interest

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rate environment.

- Income tax expense for the year ended December 31, 2022 was \$27.8 million, compared to \$18.2 million for the year ended December 31, 2021. The effective tax rate for the year ended December 31, 2022 was 29.5%, compared to 27.6% for the year ended December 31, 2021.

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

- Cash, interest bearing deposits in other financial institutions and securities available-for-sale, at fair value, decreased (43%) to \$796.2 million at December 31, 2022, from \$1.408 billion at December 31, 2021.
- Securities held-to-maturity, at amortized cost, totaled \$715.0 million at December 31, 2022, compared to \$658.4 million at December 31, 2021.
- Loans, excluding loans held-for-sale, increased \$211.2 million, or 7%, to \$3.299 billion at December 31, 2022, compared to \$3.087 billion at December 31, 2021.
- Total loans at December 31, 2022, included \$1.2 million of PPP loans, compared to \$88.7 million at December 31, 2021. Total loans at December 31, 2022 included \$537.9 million of residential mortgages, compared to \$416.7 million at December 31, 2021. Loans, excluding loans held-for-sale, PPP loans and residential mortgages, increased \$175.5 million, or 7%, to \$2.760 billion at December 31, 2022, compared to \$2.584 billion at December 31, 2021.
- Nonperforming assets (“NPAs”) were \$2.4 million, or 0.05% of total assets at December 31, 2022, compared to \$3.7 million, or 0.07% of total assets at December 31, 2021.
- Classified assets were \$14.5 million, or 0.28% of total assets, at December 31, 2022, compared to \$33.7 million, or 0.61% of total assets, at December 31, 2021.
- Net recoveries totaled \$3.5 million for the year ended December 31, 2022, compared to net recoveries of \$2.0 million for the year ended December 31, 2021.
- The ACLL at December 31, 2022, was \$47.5 million, or 1.44% of total loans, representing 1,959.26% of nonperforming loans. The ACLL at December 31, 2021, was \$43.3 million, or 1.40% of total loans, representing 1,158.11% of nonperforming loans.
- Total deposits decreased (\$369.8) million, or (8%), to \$4.390 billion at December 31, 2022, compared to \$4.759 billion at December 31, 2021.
- Deposits, excluding all time deposits and CDARS deposits, decreased (\$369.1) million, or (8%), to \$4.219 billion at December 31, 2022, compared to \$4.588 billion at December 31, 2021.
- Off-balance sheet deposits increased \$9.4 million, or 4%, to \$254.4 million at December 31, 2022, compared to \$245.0 million at December 31, 2021.
- The ratio of noncore funding (which consists of time deposits of \$250,000 and over, CDARS deposits, brokered deposits, securities under agreement to repurchase, subordinated debt and short-term borrowings) to total assets was 3.45% at December 31, 2022, compared to 3.14% at December 31, 2021.
- The loan to deposit ratio was 75.14% at December 31, 2022, compared to 64.87% at December 31, 2021.

- The Company's consolidated capital ratios exceeded regulatory guidelines and the Bank's capital ratios exceeded regulatory guidelines for a well-capitalized financial institution under the Basel III regulatory requirements at December 31, 2022.

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Capital Ratios	Heritage Commerce Corp	Heritage Bank of Commerce	Well-capitalized Financial Institution Basel III PCA Regulatory Guidelines	Basel III Minimum Regulatory Requirement(1)
Total Capital	14.8 %	14.2 %	10.0 %	10.5 %
Tier 1 Capital	12.7 %	13.2 %	8.0 %	8.5 %
Common Equity Tier 1 Capital	12.7 %	13.2 %	6.5 %	7.0 %
Tier 1 Leverage	9.2 %	9.5 %	5.0 %	4.0 %

(1) Basel III minimum regulatory requirements for both HCC and HBC include a 2.5% capital conservation buffer, except the leverage ratio.

RESULTS OF OPERATIONS

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

Net Interest Income and Net Interest Margin

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

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

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	Year Ended December 31,								
	2022			2021			2020		
	Average Balance	Interest Income / Expense	Average Yield / Rate	Average Balance	Interest Income / Expense	Average Yield / Rate	Average Balance	Interest Income / Expense	Average Yield / Rate
(Dollars in thousands)									
Assets:									
Loans, gross ⁽¹⁾⁽²⁾	\$ 3,119,006	\$ 153,010	4.91 %	\$ 2,766,321	\$ 139,244	5.03 %	\$ 2,631,495	\$ 133,169	5.06 %
Securities — taxable	983,137	20,666	2.10 %	534,387	8,678	1.62 %	578,506	11,637	2.01 %
Securities — exempt from Federal tax ⁽³⁾	40,478	1,372	3.39 %	60,566	1,995	3.29 %	74,849	2,415	3.23 %
Other investments, interest-bearing deposits in other financial institutions and Federal funds sold	908,931	14,068	1.55 %	1,444,356	3,758	0.26 %	786,955	3,757	0.48 %
Total interest earning assets ⁽³⁾	5,051,552	189,116	3.74 %	4,805,630	153,675	3.20 %	4,071,805	150,978	3.71 %
Cash and due from banks	37,287			39,841			40,401		
Premises and equipment, net	9,574			10,056			9,497		
Goodwill and other intangible assets	180,061			182,887			186,239		
Other assets	122,746			127,880			126,387		
Total assets	<u>\$ 5,401,220</u>			<u>\$ 5,166,294</u>			<u>\$ 4,434,329</u>		
Liabilities and shareholders' equity:									
Deposits:									
Demand, noninterest-bearing	\$ 1,863,928			\$ 1,834,909			\$ 1,638,055		
Demand, interest-bearing	1,224,676	2,415	0.20 %	1,164,556	1,988	0.17 %	891,513	2,035	0.23 %
Savings and money market	1,394,283	3,720	0.27 %	1,251,438	2,195	0.18 %	1,026,319	3,144	0.31 %
Time deposits — under \$100	12,587	21	0.17 %	14,924	29	0.19 %	17,659	67	0.38 %
Time deposits — \$100 and over	122,018	609	0.50 %	128,753	598	0.46 %	128,461	1,009	0.79 %
CDARS — interest-bearing demand, money market and time deposits	29,708	5	0.02 %	32,305	6	0.02 %	17,889	5	0.03 %
Total interest-bearing deposits	2,783,272	6,770	0.24 %	2,591,976	4,816	0.19 %	2,081,841	6,260	0.30 %
Total deposits	4,647,200	6,770	0.15 %	4,426,885	4,816	0.11 %	3,719,896	6,260	0.17 %
Subordinated debt, net of issuance costs	41,739	2,178	5.22 %	39,827	2,314	5.81 %	39,641	2,320	5.85 %
Short-term borrowings	24	—	— %	45	1	2.22 %	139	1	0.72 %
Total interest-bearing liabilities	2,825,035	8,948	0.32 %	2,631,848	7,131	0.27 %	2,121,621	8,581	0.40 %
Total interest-bearing liabilities and demand,									
noninterest-bearing / cost of funds	4,688,963	8,948	0.19 %	4,466,757	7,131	0.16 %	3,759,676	8,581	0.23 %
Other liabilities	<u>104,654</u>			<u>114,381</u>			<u>97,978</u>		
Total liabilities	4,793,617			4,581,138			3,857,654		
Shareholders' equity	<u>607,603</u>			<u>585,156</u>			<u>576,675</u>		
Total liabilities and shareholders' equity	<u>\$ 5,401,220</u>			<u>\$ 5,166,294</u>			<u>\$ 4,434,329</u>		
Net interest income ⁽³⁾ / margin	180,168	3.57 %		146,544	3.05 %		142,397	3.50 %	
Less tax equivalent adjustment ⁽³⁾	(288)			(419)			(507)		
Net interest income	<u>\$ 179,880</u>			<u>\$ 146,125</u>			<u>\$ 141,890</u>		

- (1) Includes loans held-for-sale. Nonaccrual loans are included in average balance.
- (2) Yield amounts earned on loans include fees and costs. The accretion of net deferred loan fees into loan interest income was \$3.4 million for the year ended December 31, 2022 (of which \$2.1 million was from PPP loans), compared to \$11.3 million for the year ended December 31, 2021 (of which \$10.0 million was from PPP loans), and \$4.5 million for the year ended December 31, 2020 (of which \$3.9 million were from PPP loans). Prepayment fees totaled \$1.3 million for the year ended December 31, 2022, compared to \$2.7 million for the year ended December 31, 2021, and \$1.1 million for the year ended December 31, 2020.
- (3) Reflects tax equivalent adjustment for Federal tax exempt income based on a 21% tax rate for the years ended December 31, 2022, 2021 and 2020.

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

	Year Ended December 31, 2022 vs. 2021			Year Ended December 31, 2021 vs. 2020		
	Increase (Decrease) Due to Change in:			Increase (Decrease) Due to Change in:		
	Average Volume	Average Rate	Net Change	Average Volume	Average Rate	Net Change
	(Dollars in thousands)					
Income from the interest earning assets:						
Loans, gross	\$17,184	\$ (3,418)	\$13,766	\$6,880	\$ (805)	\$ 6,075
Securities — taxable	9,444	2,544	11,988	(694)	(2,265)	(2,959)
Securities — exempt from Federal tax ⁽¹⁾	(681)	58	(623)	(468)	48	(420)
Other investments, interest-bearing deposits in other financial institutions and Federal funds sold	(8,320)	18,630	10,310	1,712	(1,711)	1
Total interest income on interest-earning assets	<u>17,627</u>	<u>17,814</u>	<u>35,441</u>	<u>7,430</u>	<u>(4,733)</u>	<u>2,697</u>
Expense from the interest-bearing liabilities:						
Demand, interest-bearing	86	341	427	472	(519)	(47)
Savings and money market	341	1,184	1,525	348	(1,297)	(949)
Time deposits — under \$100	(4)	(4)	(8)	(5)	(33)	(38)
Time deposits — \$100 and over	(35)	46	11	7	(418)	(411)
CDARS — interest-bearing demand, money market and time deposits	(1)	—	(1)	2	(1)	1
Subordinated debt, net of issuance costs	99	(235)	(136)	11	(17)	(6)
Short-term borrowings	—	(1)	(1)	(2)	2	—
Total interest expense on interest-bearing liabilities	<u>486</u>	<u>1,331</u>	<u>1,817</u>	<u>833</u>	<u>(2,283)</u>	<u>(1,450)</u>
Net interest income	<u>\$17,141</u>	<u>\$16,483</u>	<u>33,624</u>	<u>\$6,597</u>	<u>\$(2,450)</u>	<u>4,147</u>
Less tax equivalent adjustment			<u>131</u>			<u>88</u>
Net interest income			<u>\$33,755</u>			<u>\$ 4,235</u>

(1) Reflects tax equivalent adjustment for Federal tax exempt income based on a 21% tax rate for the years ended December 31, 2022, 2021 and 2020.

Net interest income increased 23% to \$179.9 million for the year ended December 31, 2022, compared to \$146.1 million for the year ended December 31, 2021. For the year ended December 31, 2022, the FTE net interest margin increased 52 basis points to 3.57%, compared to 3.05% for the year ended December 31, 2021, primarily due to higher average balances of loans and investment securities, higher average yields on investment securities and overnight funds, partially offset by lower interest and fees on PPP loans, a decrease in the accretion of the loan purchase discount into interest income from acquired loans, lower prepayment fees, a lower yield on the Bay View Funding factoring portfolio, and a higher cost of funds.

Net interest income increased 3% to \$146.1 million for the year ended December 31, 2021, compared to \$141.9 million for the year ended December 31, 2020. For the year ended December 31, 2021, the FTE net interest margin contracted 45 basis points to 3.05% for the year ended December 31, 2021, compared to 3.50% for the year ended December 31, 2020, primarily due to a decline in the average yields on loans, investment securities, and overnight funds, and a shift in the mix of earning assets toward lower yielding shorter term investments, partially offset by an increase in the accretion of the loan purchase discount into interest income from acquired loans, higher interest and fee income from PPP loans, higher loan prepayment fees, and lower costs of deposits.

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The following tables present the average balance of loans outstanding, interest income, and the average yield for the periods indicated:

	Year Ended December 31,								
	2022			2021			2020		
	Average Balance	Interest Income	Average Yield	Average Balance	Interest Income	Average Yield	Average Balance	Interest Income	Average Yield
(Dollars in thousands)									
Loans, core bank	\$2,561,195	\$117,582	4.59 %	\$2,299,367	\$101,690	4.42 %	\$2,297,938	\$107,780	4.69 %
Prepayment fees	—	1,278	0.05 %	—	2,700	0.12 %	—	1,121	0.05 %
PPP loans	21,689	213	0.98 %	249,253	2,481	1.00 %	218,391	2,185	1.00 %
PPP fees, net	—	2,054	9.47 %	—	9,995	4.01 %	—	3,877	1.78 %
Asset-based lending	51,990	3,613	6.95 %	39,798	2,106	5.29 %	29,686	1,751	5.90 %
Bay View Funding factored receivables	64,099	12,819	20.00 %	52,618	11,485	21.83 %	45,765	10,727	23.44 %
Purchased residential mortgages	417,672	12,395	2.97 %	122,566	3,555	2.90 %	29,648	725	2.45 %
Purchased CRE loans	8,143	317	3.89 %	12,436	441	3.55 %	24,072	831	3.45 %
Loan credit mark / accretion	(5,782)	2,739	0.11 %	(9,717)	4,791	0.21 %	(14,005)	4,172	0.18 %
Total loans (includes loans held-for-sale)	<u>\$3,119,006</u>	<u>\$153,010</u>	<u>4.91 %</u>	<u>\$2,766,321</u>	<u>\$139,244</u>	<u>5.03 %</u>	<u>\$2,631,495</u>	<u>\$133,169</u>	<u>5.06 %</u>

The average yield on the total loan portfolio decreased to 4.91% for the year ended December 31, 2022, compared to 5.03% for the year ended December 31, 2021, primarily due to a decrease in interest and fees on PPP loans, a decrease in the accretion of the loan purchase discount into interest income from acquired loans, lower prepayment fees, and an increase in the average balance of lower yielding purchased residential mortgages. The average yield on the total loan portfolio decreased to 5.03% for the year ended December 31, 2021, compared to 5.06% for the year ended December 31, 2020, primarily due to a decline in the average yield on core bank loans, and increases in the average balances of lower yielding purchased residential mortgages, partially offset by increases in interest and fees on PPP loans, higher loan prepayment fees, and an increase in the accretion of the loan purchase discount into interest income from acquired loans. There were higher fees recognized into income on PPP loans for the year ended December 31, 2021, compared to the year ended December 31, 2020, primarily as a result of accelerated forgiveness of the PPP loans by the SBA.

In aggregate, the remaining net purchase discount on total loans acquired was \$4.6 million at December 31, 2022.

The average cost of deposits was 0.15% for the year ended December 31, 2022, compared to 0.11% for the year ended December 31, 2021, and 0.17% for the year ended December 31, 2020.

Provision for Credit Losses on Loans

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

There was a \$766,000 provision for credit losses on loans for the year ended December 31, 2022, compared to a \$3.1 million negative provision for credit losses on loans for the year ended December 31, 2021, and a \$13.2 million provision for credit losses on loans for the year ended December 31, 2020. The higher provision for credit losses on loans for the year ended December 31, 2020 was driven primarily by a significantly deteriorating economic outlook resulting from the Coronavirus pandemic. Provisions for credit losses on loans are charged to operations to bring the allowance for credit losses on loans to a level deemed

appropriate by the Company based on the factors discussed under “*Credit Quality and Allowance for Credit Losses on Loans.*”

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Noninterest Income

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

	Year Ended December 31,			Increase (decrease)		Increase (Decrease)	
				2022 versus 2021	Percent	2021 versus 2020	Percent
	2022	2021	2020	Amount		Amount	Percent
(Dollars in thousands)							
Service charges and fees on deposit accounts	\$ 4,640	\$2,488	\$2,859	\$ 2,152	86 %	\$ (371)	(13)%
Increase in cash surrender value of life insurance	1,925	1,838	1,845	87	5 %	(7)	(0)%
Gain on warrants	669	11	449	658	5,982 %	(438)	(98)%
Servicing income	508	553	673	(45)	(8)%	(120)	(18)%
Gain on sales of SBA loans	491	1,718	839	(1,227)	(71)%	879	105 %
Termination fees	61	797	89	(736)	(92)%	708	796
Gain on proceeds from company-owned life insurance	27	675	20	(648)	(96)%	655	3,275 %
Gain on the disposition of foreclosed assets	—	—	791	—	N/A	(791)	(100)%
Gain on sales of securities	—	—	277	—	N/A	(277)	(100)%
Other	1,790	1,608	2,080	182	11 %	(472)	(23)%
Total	<u>\$10,111</u>	<u>\$9,688</u>	<u>\$9,922</u>	<u>\$ 423</u>	4 %	<u>\$ (234)</u>	(2)%

For the year ended December 31, 2022, total noninterest income increased 4% to \$10.1 million, compared to \$9.7 million for the year ended December 31, 2021, primarily due to higher income on off-balance sheet deposits, and a \$669,000 gain on warrants, partially offset by a lower gain on sale of SBA loans and a lower gain on proceeds from company-owned life insurance during the year ended December 31, 2022.

For the year ended December 31, 2021, noninterest income was \$9.7 million, compared to \$9.9 million for the year ended December 31, 2020, primarily due to lower service charges and fees on deposits accounts and servicing income during 2021, and a \$791,000 gain on disposition of foreclosed assets, a \$449,000 gain on warrants, and a \$277,000 gain on the sale of securities during 2020. These decreases were partially offset by a higher gain on sales of SBA loans, higher termination fees at Bay View Funding, and a \$675,000 gain on proceeds for company owned life insurance during 2021.

A portion of the Company's noninterest income is associated with its SBA lending activity, as gain on sales of loans sold in the secondary market and servicing income from loans sold with servicing rights retained. During 2022, SBA loan sales resulted in a \$491,000 gain, compared to a \$1.7 million gain on sales of SBA loans in 2021, and an \$839,000 gain on sales of SBA loans in 2020.

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

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Noninterest Expense

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

	Year Ended December 31,		Increase (Decrease)		Increase (Decrease)		
	2022	2021	2020	Amount	Percent	2021	2020
	(Dollars in thousands)						
Salaries and employee benefits	\$55,331	\$51,862	\$50,571	\$ 3,469	7 %	1,291	3 %
Occupancy and equipment	9,639	9,038	8,018	601	7 %	1,020	13 %
Professional fees	5,015	5,901	5,338	(886)	(15)%	563	11 %
Insurance expense	4,958	3,270	2,286	1,688	52 %	984	43 %
Amortization of intangible assets	2,635	2,996	3,751	(361)	(12)%	(755)	(20)%
Data processing	2,482	2,146	2,770	336	16 %	(624)	(23)%
Reserve for litigation	—	4,500	—	(4,500)	(100)%	4,500	NA
Other	14,799	13,337	14,176	1,462	11 %	(839)	(6)%
Total noninterest expense	<u>\$94,859</u>	<u>\$93,050</u>	<u>86,910</u>	<u>\$ 1,809</u>	<u>2 %</u>	<u>6,140</u>	<u>7 %</u>
Salaries and employee benefits merger-related costs (2)	—	—	356	—	NA	(356)	(100)%
Other merger-related costs (1)	—	27	2,245	(27)	(100)%	(2,218)	(99)%
Total noninterest expense, including merger-related costs	<u>\$94,859</u>	<u>\$93,077</u>	<u>\$89,511</u>	<u>\$ 1,782</u>	<u>2 %</u>	<u>3,566</u>	<u>4 %</u>

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

	Year Ended December 31,			
	2022	Percent of Total	2021	Percent of Total
		(Dollars in thousands)		2020
Salaries and employee benefits	\$55,331	58 %	\$51,862	56 %
Occupancy and equipment	9,639	10 %	9,038	10 %
Professional fees	5,015	5 %	5,901	6 %
Insurance expense	4,958	5 %	3,270	4 %
Amortization of intangible assets	2,635	3 %	2,996	3 %
Data processing	2,482	3 %	2,146	2 %
Reserve for litigation	—	0 %	4,500	5 %
Other	14,799	16 %	13,337	14 %
Total noninterest expense	<u>\$94,859</u>	<u>100 %</u>	<u>\$93,050</u>	<u>100 %</u>
Salaries and employee benefits merger-related costs (2)	—	0 %	—	0 %
Other merger-related costs (1)	—	0 %	27	0 %
Total noninterest expense, including merger-related costs	<u>\$94,859</u>	<u>100 %</u>	<u>\$93,077</u>	<u>100 %</u>

(1) Included in "Salaries and employee benefits" category in the Consolidated Statements of Income.

(2) Included in the "Other noninterest expense" category in the Consolidated Statements of Income.

Noninterest expense for the year ended December 31, 2022 increased to \$94.9 million, compared to \$93.1 million for the year ended December 31, 2021, primarily due to higher salaries and employee benefits, higher rent included in occupancy and equipment expense, and higher insurance and information technology

related expenses during the year ended December 31, 2022. These increases during 2022 were partially offset by higher legal fees included in professional fees and a reserve for a legal settlement included in other noninterest expense during the year ended December 31, 2021.

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Noninterest expense for the year ended December 31, 2021 increased to \$93.1 million, compared to \$89.5 million for the year ended December 31, 2020, primarily due to a \$4.0 million reserve for a litigation matter that settled in the second quarter of 2021, partially offset by lower merger-related costs.

Full-time equivalent employees were 340 at December 31, 2022, and 326 at December 31, 2021, and 331 at December 31, 2020.

Income Tax Expense

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

The following table shows the effective tax rate for the dates indicated:

	Year Ended December 31,		
	2022	2021	2020
Effective income tax rate	29.5%	27.6%	28.1%

The Company's Federal and state income tax expense in 2022 was \$27.8 million, compared to \$18.2 million in 2021, and \$13.8 million in 2020.

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

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

The Company had the net deferred tax assets of \$32.2 million and \$28.8 million at December 31, 2022, and December 31, 2021, respectively. After consideration of the matters in the preceding paragraph, the Company determined that it is more likely than not that the net deferred tax assets at December 31, 2022 and December 31, 2021 will be fully realized in future years.

FINANCIAL CONDITION

As of December 31, 2022, total assets decreased (6%) to \$5.157 billion, compared to \$5.499 billion at December 31, 2021. Securities available-for-sale, at fair value, were \$489.6 million at December 31, 2022, an increase of 379% from \$102.3 million at December 31, 2021. Securities held-to-maturity, at amortized cost, were \$715.0 million at December 31, 2022, an increase of 9% from \$658.4 million at December 31, 2021.

Total loans, excluding loans held-for-sale, increased \$211.2 million, or 7%, to \$3.299 billion at December 31, 2022, compared to \$3.087 billion at December 31, 2021. Total loans at December 31, 2022, included \$1.2 million of PPP loans, compared to \$88.7 million at December 31, 2021. Total loans at December 31, 2022, included \$537.9 million of

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residential mortgages, compared to \$416.7 million at December 31, 2021. Loans, excluding loans held-for-sale, PPP loans and residential mortgages, increased \$175.5 million, or 7%, to \$2.760 billion at December 31, 2022, compared to \$2.584 billion at December 31, 2021.

Total deposits decreased (\$369.8) million, or (8%), to \$4.390 billion at December 31, 2022, compared to \$4.759 billion at December 31, 2021. Deposits, excluding all time deposits and CDARS deposits, decreased (\$369.1) million, or (8%), to \$4.219 billion at December 31, 2022, from \$4.588 billion at December 31, 2021.

Securities Portfolio

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

	December 31,	
	2022	2021
	(Dollars in thousands)	
Securities available-for-sale (at fair value):		
U.S. Treasury	\$ 418,474	\$ —
Agency mortgage-backed securities	71,122	102,252
Total	<u>\$ 489,596</u>	<u>\$ 102,252</u>
Securities held-to-maturity (at amortized cost):		
Agency mortgage-backed securities	\$ 677,381	\$ 607,377
Municipals — exempt from Federal tax	37,623	51,063
Total	<u>\$ 715,004</u>	<u>\$ 658,440</u>

The table below summarizes the weighted average life and weighted average yields of securities as of December 31, 2022:

	Weighted Average Life									
	Within One Year or Less		After One and Within Five Years		After Five and Within Ten Years		After Ten Years		Total	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
	(Dollars in thousands)									
Securities available-for-sale (at fair value):										
U.S. Treasury	\$45,736	3.67 %	\$372,738	2.99 %	\$ —	— %	\$ —	— %	\$418,474	3.06 %
Agency mortgage-backed securities	<u>161</u>	2.26 %	<u>59,164</u>	2.48 %	<u>11,797</u>	2.63 %	<u>—</u>	— %	<u>71,122</u>	2.50 %
Total	<u><u>\$45,897</u></u>	<u>3.67 %</u>	<u><u>\$431,902</u></u>	<u>2.92 %</u>	<u><u>\$ 11,797</u></u>	<u>2.63 %</u>	<u><u>\$ —</u></u>	<u>— %</u>	<u><u>\$489,596</u></u>	<u>2.98 %</u>
Securities held-to-maturity (at amortized cost):										
Agency mortgage-backed securities	\$ 124	2.51 %	\$ 71,942	2.21 %	\$ 508,424	1.78 %	\$ 96,891	2.81 %	\$677,381	1.98 %
Municipals — exempt from Federal tax (1)	<u>10,463</u>	3.67 %	<u>3,355</u>	3.04 %	<u>22,867</u>	3.36 %	<u>938</u>	3.64 %	<u>37,623</u>	3.43 %
Total	<u><u>\$10,587</u></u>	<u>3.66 %</u>	<u><u>\$ 75,297</u></u>	<u>2.24 %</u>	<u><u>\$531,291</u></u>	<u>1.85 %</u>	<u><u>\$97,829</u></u>	<u>2.82 %</u>	<u><u>\$715,004</u></u>	<u>2.05 %</u>

(1) Reflects tax equivalent adjustment for Federal tax exempt income based on a 21% tax rate.

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

The Company's portfolio may include: (i) U.S. Treasury securities and U.S. Government sponsored entities' debt securities for liquidity and pledging; (ii) mortgage-backed securities, which in many instances can also be used for pledging, and which generally enhance the yield of the portfolio; (iii) municipal

obligations, which provide tax free income and limited pledging potential; (iv) single entity issue trust preferred securities, which generally enhance the yield on the

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portfolio; (v) corporate bonds, which also enhance the yield on the portfolio; (vi) money market mutual funds; (vii) certificates of deposit; (viii) commercial paper; (ix) bankers acceptances; (x) repurchase agreements; (xi) collateralized mortgage obligations; and (xii) asset-backed securities.

The Company classifies its securities as either available-for-sale or held-to-maturity at the time of purchase. Accounting guidance requires available-for-sale securities to be marked to fair value with an offset to accumulated other comprehensive income (loss), a component of shareholders' equity. Monthly adjustments are made to reflect changes in the fair value of the Company's available-for-sale securities.

The net unrealized loss on U.S. Treasury securities available-for-sale at December 31, 2022 was (\$10.3) million. There were no U.S. Treasury securities available-for-sale at December 31, 2021. The net unrealized loss on mortgage-backed securities available-for-sale at December 31, 2022 was (\$5.8) million, compared to a net unrealized gain of \$2.9 million at December 31, 2021. The net unrealized loss on total securities available-for-sale at December 31, 2022 was (\$16.1) million, compared to a net unrealized gain of \$2.9 million at December 31, 2021. All other factors remaining the same, when market interest rates are increasing, the Company will experience a higher unrealized loss in the securities portfolio.

The net unrealized loss on mortgage-backed securities held-to-maturity at December 31, 2022 was (\$99.7) million, compared to a net unrealized loss of (\$1.6) million at December 31, 2021. The net unrealized loss on municipal bonds held-to-maturity at December 31, 2022 was (\$810,000), compared to a net unrealized gain of \$805,000 at December 31, 2021. The net unrealized loss on total securities held-to-maturity at December 31, 2022 was (\$100.6) million, compared to a net unrealized loss of (\$790,000) at December 31, 2021.

During the year ended December 31, 2022, the Company purchased \$425.7 million of U.S. Treasury securities available-for-sale, with a book yield of 3.08% and an average life of 2.25 years. The Company has not used interest rate swaps or other derivative instruments to hedge fixed rate loans or securities to otherwise mitigate interest rate risk. During the year ended December 31, 2022, the Company purchased \$146.6 million of agency mortgage-backed securities held-to-maturity, with a book yield of 2.75% and an average life of 6.92 years.

The average life of the total investment securities portfolio was 4.93 years at December 31, 2022.

Loans

The Company's loans represent the largest portion of earning assets, substantially greater than the securities portfolio or any other asset category, and the quality and diversification of the loan portfolio is an important consideration when reviewing the Company's financial condition. Gross loans, excluding loans held-for-sale, represented 64% of total assets at December 31, 2022 and 56% at December 31, 2021. The ratio of loans to deposits increased to 75.14% at December 31, 2022 from 64.87% at December 31, 2021.

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Loan Distribution

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

	December 31, 2022		December 31, 2021	
	Balance	% to Total	Balance	% to Total
Commercial	\$ 532,749	16 %	\$ 594,108	19 %
PPP loans ⁽¹⁾	1,166	0 %	88,726	3 %
Real estate:			(Dollars in thousands)	
CRE - owner occupied	614,663	19 %	595,934	19 %
CRE - non-owner occupied	1,066,368	32 %	902,326	29 %
Land and construction	163,577	5 %	147,855	5 %
Home equity	120,724	4 %	109,579	4 %
Multifamily	244,882	7 %	218,856	7 %
Residential mortgages	537,905	16 %	416,660	13 %
Consumer and other	17,033	1 %	16,744	1 %
Total Loans	3,299,067	100 %	3,090,788	100 %
Deferred loan fees, net	(517)	—	(3,462)	—
Loans, net of deferred fees	3,298,550	100 %	3,087,326	100 %
Allowance for credit losses on loans	(47,512)	—	(43,290)	—
Loans, net	\$ 3,251,038	—	\$ 3,044,036	—

(1) Less than 1% at December 31, 2022.

The Company's loan portfolio is concentrated in commercial (primarily manufacturing, wholesale, and services oriented entities) and commercial real estate, with the remaining balance in land development and construction and home equity, purchased residential mortgages, and consumer loans. The Company does not have any concentrations by industry or group of industries in its loan portfolio, however, 83% of its gross loans were secured by real property as of December 31, 2022, compared to 77% as of December 31, 2021. While no specific industry concentration is considered significant, the Company's lending operations are located in areas that are dependent on the technology and real estate industries and their supporting companies.

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

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

The Company is an active participant in the SBA and U.S. Department of Agriculture guaranteed lending programs, and has been approved by the SBA as a lender under the Preferred Lender Program. The Company regularly makes such loans conditionally guaranteed by the SBA (collectively referred to as "SBA loans"). The guaranteed portion of these loans is typically sold in the secondary market depending on market conditions. When the guaranteed portion of an SBA loan is sold the Company retains the servicing rights for the sold portion. During 2022, loans were sold resulting in a gain on sales of SBA loans of \$491,000, compared to a gain on sales of SBA loans of \$1.7 million for 2021, and \$839,000 for 2020.

The Company's factoring receivables are from the operations of Bay View Funding whose primary business is purchasing and collecting factored receivables. Factored receivables are receivables that have been transferred by the originating organization and typically have not been subject to previous collection efforts. These receivables are acquired from a variety of companies, including, but not limited to, service providers,

transportation companies, manufacturers, distributors, wholesalers, apparel companies, advertisers, and temporary staffing companies. The portfolio of factored

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receivables is included in the Company's commercial loan portfolio. The average life of the factored receivables was 38 days for the year ended December 31, 2022, and 37 days for both of the years ended December 31, 2021 and December 31, 2020. The balance of the purchased receivables as of December 31, 2022 and December 31, 2021 was \$79.3 million and \$53.2 million, respectively.

The commercial loan portfolio, excluding PPP loans, decreased (\$61.4) million, or (10%), to \$532.7 million at December 31, 2022, from \$594.1 million at December 31, 2021. Commercial and industrial ("C&I") line usage was 29% at December 31, 2022, compared to 31% at December 31, 2021. In addition, the Company had \$1.2 million in PPP loans at December 31, 2022, compared to \$88.7 million at December 31, 2021.

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

The CRE owner occupied loan portfolio increased \$18.7 million, or 3% to \$614.6 million at December 31, 2022, from \$595.9 million at December 31, 2021. CRE non-owner occupied loans increased \$164.0 million, or 18% to \$1,066.4 billion at December 31, 2022, from \$902.3 million at December 31, 2021. At December 31, 2022, 37% of the CRE loan portfolio was secured by owner occupied real estate, compared to 40% at December 31, 2021.

The Company's land and construction loans are primarily to finance the development/construction of commercial and single family residential properties. The Company utilizes underwriting guidelines to assess the likelihood of repayment from sources such as sale of the property or availability of permanent mortgage financing prior to making the construction loan. Construction loans are provided primarily in our market area, and we have extensive controls for the disbursement process. Land and construction loans increased \$15.7 million, or 11%, to \$163.6 million at December 31, 2022, from \$147.9 million at December 31, 2021.

The Company makes home equity lines of credit available to its existing customers. Home equity lines of credit are underwritten initially with a maximum 75% loan to value ratio. Home equity lines of credit increased \$11.1 million, or 10%, to \$120.7 million at December 31, 2022, from \$109.6 million at December 31, 2021.

Multifamily loans increased \$26.0 million, or 12%, to \$244.9 million at December 31, 2022, compared to \$218.9 million at December 31, 2021.

Residential mortgage loans increased \$121.2 million, or 29%, to \$537.9 million, at December 31, 2022, compared to \$416.7 million at December 31, 2021.

During the year ended December 31, 2021, the Company purchased single family residential mortgage loans totaling \$185.4 million, tied to homes all located in California, with average principal balances of approximately \$950,000. Purchases of residential loans have been an attractive alternative for replacing mortgage-backed security paydowns in the investment securities portfolio.

Additionally, the Company makes consumer loans for the purpose of financing automobiles, various types of consumer goods, and other personal purposes. Consumer loans generally provide for the monthly payment of principal and interest. Most of the Company's consumer loans are secured by the personal property being purchased or, in the instances of home equity loans or lines of credit, real property. Consumer and other loans increased \$289,000, or 2%, to \$17.0 million at December 31, 2022, compared to \$16.7 million at December 31, 2021.

With certain exceptions, state chartered banks are permitted to make extensions of credit to any one borrowing entity up to 15% of the bank's capital and reserves for unsecured loans and up to 25% of the bank's capital and reserves for secured loans. For HBC, these lending limits were \$104.6 million and \$174.3 million at December 31, 2022, respectively.

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Loan Maturities

The following table presents the maturity distribution of the Company's loans (excluding loans held-for-sale), as of December 31, 2022. 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, 2022, approximately 33% of the Company's loan portfolio consisted of floating interest rate loans.

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	Due in One Year or Less	Over One Year But Less than Five Years (Dollars in thousands)	Over Five Years	Total
Commercial	\$ 307,385	\$ 170,450	\$ 54,914	\$ 532,749
PPP loans	—	1,166	—	1,166
Real estate:				
CRE - owner occupied	31,303	128,214	455,146	614,663
CRE - non-owner occupied	26,227	275,466	764,675	1,066,368
Land and construction	150,525	7,223	5,829	163,577
Home equity	3,934	36,077	80,713	120,724
Multifamily	16,094	87,550	141,238	244,882
Residential mortgages	5,129	20,719	512,057	537,905
Consumer and other	11,453	4,021	1,559	17,033
Loans	<u>\$ 552,050</u>	<u>\$ 730,886</u>	<u>\$ 2,016,131</u>	<u>\$ 3,299,067</u>
Loans with variable interest rates	\$ 484,522	\$ 259,477	\$ 331,652	\$ 1,075,651
Other loans with fixed interest rates	67,528	471,409	1,684,479	2,223,416
Loans	<u>\$ 552,050</u>	<u>\$ 730,886</u>	<u>\$ 2,016,131</u>	<u>\$ 3,299,067</u>

Loan Servicing

As of December 31, 2022, 2021, and 2020, SBA loans that were serviced by the Company for others totaled \$64.8 million, \$73.3 million, and \$78.0 million, respectively. Activity for loan servicing rights was as follows:

	Year Ended December 31,		
	2022	2021	2020
Beginning of period balance	\$ 655	\$ 531	\$ 583
Additions	124	384	213
Amortization	(230)	(260)	(265)
End of period balance	<u>\$ 549</u>	<u>\$ 655</u>	<u>\$ 531</u>

Loan servicing rights are included in accrued interest receivable and other assets on the consolidated balance sheets and reported net of amortization. There was no valuation allowance as of December 31, 2022 and 2021, as the fair market value of the assets was greater than the carrying value.

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

	Year Ended December 31,		
	2022	2021	2020
Beginning of period balance	\$ 221	\$ 305	\$ 503
Unrealized holding gain loss	(69)	(84)	(198)
End of period balance	<u>\$ 152</u>	<u>\$ 221</u>	<u>\$ 305</u>

Management reviews the key economic assumptions used to estimate the fair value of I/O strip receivables on a quarterly basis. The fair value of the I/O strip can be adversely impacted by a significant increase in either the prepayment speed of the portfolio or the discount rate. At December 31, 2022, key economic assumptions and the sensitivity of the

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fair value of the I/O strip receivables to immediate changes to the CPR assumption of 10% and 20%, and changes to the discount rate assumption of 1% and 2%, are as follows:

	(Dollars in thousands)
Carrying amount/fair value of Interest-Only (I/O) strip	\$ 152
Prepayment speed assumption (annual rate)	15.1%
Impact on fair value of 10% adverse change in prepayment speed (CPR 16.6%)	\$ (1)
Impact on fair value of 20% adverse change in prepayment speed (CPR 18.1%)	\$ (3)
Residual cash flow discount rate assumption (annual)	20.7%
Impact on fair value of 1% adverse change in discount rate (21.0% discount rate)	\$ (3)
Impact on fair value of 2% adverse change in discount rate (21.2% discount rate)	\$ (6)

Off-Balance Sheet Arrangements

In the normal course of business, the Company makes commitments to extend credit to its customers as long as there are no violations of any conditions established in contractual arrangements. These commitments are obligations that represent a potential credit risk to the Company, yet are not reflected in any form within the Company's consolidated balance sheets. Total unused commitments to extend credit were \$1.1 billion and \$1.2 billion at December 31, 2022 and December 31, 2021, respectively. Unused commitments represented 34% and 37% of outstanding gross loans at December 31, 2022 and December 31, 2021, respectively.

The effect on the Company's revenues, expenses, cash flows and liquidity from the unused portion of the commitments to provide credit cannot be reasonably predicted, because there is no certainty that the lines of credit will ever be fully utilized. For more information regarding the Company's off-balance sheet arrangements, see Note 15 to the consolidated financial statements located elsewhere herein.

Credit Quality and Allowance for Credit Losses on Loans

Financial institutions generally have a certain level of exposure to credit quality risk, and could potentially receive less than a full return of principal and interest if a debtor becomes unable or unwilling to repay. Since loans are the most significant assets of the Company and generate the largest portion of its revenues, the Company's management of credit quality risk is focused primarily on loan quality. Banks have generally suffered their most severe earnings declines as a result of customers' inability to generate sufficient cash flow to service their debts and/or downturns in national and regional economies and declines in overall asset values including real estate. In addition, certain debt securities that the Company may purchase have the potential of declining in value if the obligor's financial capacity to repay deteriorates.

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

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

Nonperforming assets are comprised of the following: loans for which the Company is no longer accruing interest; restructured loans which have been current under six months; loans 90 days or more past due and still accruing interest (although they are generally placed on nonaccrual when they become 90 days past due, unless they are both well-secured and in the process of collection); and foreclosed assets. Past due loans 30 days or greater totaled \$17.1 million and \$5.0 million at December 31, 2022 and December 31, 2021, respectively, of which \$479,000 and \$1.3 million were on nonaccrual. There were also \$261,000 and \$2.2 million loans less than 30 days past due included in nonaccrual loans held-

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for-investment, at December 31, 2022 and December 31, 2021, respectively.

Management's classification of a loan as "nonaccrual" is an indication that there is reasonable doubt as to the full recovery of principal or interest on the loan. At that point, the Company stops accruing interest income, and reverses any uncollected interest that had been accrued as income. The Company begins recognizing interest income only as cash interest payments are received and it has been determined the collection of all outstanding principal is not in doubt. The loans may or may not be collateralized, and collection efforts are pursued. Loans may be restructured by management when a borrower has experienced some change in financial status causing an inability to meet the original repayment terms and where the Company believes the borrower will eventually overcome those circumstances and make full restitution. Foreclosed assets consist of properties and other assets acquired by foreclosure or similar means that management is offering or will offer for sale.

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

	December 31,	
	2022	2021
	(Dollars in thousands)	
Nonaccrual loans — held-for-investment	\$ 740	\$ 3,460
Restructured and loans 90 days past due and still accruing	1,685	278
Total nonperforming loans	2,425	3,738
Foreclosed assets	—	—
Total nonperforming assets	\$ 2,425	\$ 3,738
Nonperforming assets as a percentage of loans		
plus foreclosed assets	0.07 %	0.12 %
Nonperforming assets as a percentage of total assets	0.05 %	0.07 %

The following table presents the amortized cost basis of nonperforming loans and loans past due over 90 days and still accruing at the periods indicated:

	December 31, 2022				
	Nonaccrual with no Special Allowance for Credit Losses	Nonaccrual with Special Allowance for Credit Losses	Restructured and Loans over 90 Days Past Due and Still Accruing	Total	(Dollars in thousands)
Commercial	\$ 318	\$ 324	\$ 349	\$ 991	
Real estate:					
CRE - Non-Owner Occupied	—	—	1,336	1,336	
Home equity	98	—	—	98	
Total	\$ 416	\$ 324	\$ 1,685	\$ 2,425	

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	December 31, 2021				
	Nonaccrual with no Special Allowance for Credit Losses	Nonaccrual with Special Allowance for Credit Losses	Restructured and Loans over 90 Days Past Due and Still Accruing	Total	
	(Dollars in thousands)				
Commercial	\$ 94	\$ 1,028	\$ 278	\$ 1,400	
Real estate:					
CRE - Owner Occupied	1,126	—	—	1,126	
Home equity	84	—	—	84	
Multifamily	1,128	—	—	1,128	
Total	<u><u>\$ 2,432</u></u>	<u><u>\$ 1,028</u></u>	<u><u>\$ 278</u></u>	<u><u>\$ 3,738</u></u>	

Loans with a well-defined weakness, which are characterized by the distinct possibility that the Company will sustain a loss if the deficiencies are not corrected, are categorized as “classified.” Classified loans include all loans considered as substandard, substandard nonaccrual, and doubtful and may result from problems specific to a borrower’s business or from economic downturns that affect the borrower’s ability to repay or that cause a decline in the value of the underlying collateral (particularly real estate). Loans held for sale are carried at the lower of cost or estimated fair value, and are not allocated an allowance for loan losses.

The amortized cost basis of collateral-dependent commercial loans collateralized by business assets totaled \$324,000 and \$1.0 million at December 31, 2022 and December 31, 2021, respectively.

When management determines that foreclosures are probable, expected credit losses for collateral-dependent loans are based on the fair value of the collateral at the reporting date, adjusted for selling costs as appropriate. For loans which foreclosure is not probable, but for which repayment is expected to be provided substantially through the operation or sale of the collateral and the borrower is experiencing financial difficulty, management has elected the practical expedient under ASC 326 to estimate expected credit losses based on the fair value of collateral, adjusted for selling costs as appropriate. The class of loan represents the primary collateral type associated with the loan. Significant quarter over quarter changes are reflective of changes in nonaccrual status and not necessarily associated with credit quality indicators like appraisal value.

Classified loans decreased to \$14.5 million, or 0.28% of total assets, at December 31, 2022, compared to \$33.8 million, or 0.61% of total assets at December 31, 2021.

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

Beginning January 1, 2020, the ACLL is calculated by using the current expected credit loss (“CECL”) methodology. The ACLL estimation process involves procedures to appropriately consider the unique characteristics of loan portfolio segments. These segments are further disaggregated into loan classes, the level at which credit risk is monitored. When computing the level of expected credit losses, credit loss assumptions are estimated using a model that categorizes loan pools based on loss history, delinquency status, and other credit trends and risk characteristics, including current conditions and reasonable and supportable forecasts about the future. Determining the appropriateness of the allowance is complex and requires judgment by management about the effect of matters that are inherently uncertain. In future periods, evaluations of the overall loan portfolio in light of the factors and forecasts then prevailing, may result in significant changes in the allowance and credit loss expense in those future periods.

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The allowance level is influenced by loan volumes, loan risk rating migration or delinquency status, changes in historical loss experience, and other conditions influencing loss expectations, such as reasonable and supportable forecasts of economic conditions. The methodology for estimating the amount of expected credit losses reported in the allowance for credit losses has two basic components: first, an asset-specific component involving individual loans that do not share risk characteristics with other loans and the measurement of expected credit losses for such individual loans; and second, a pooled component for estimated expected credit losses for pools of loans that share similar risk characteristics.

Loans are charged-off against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance for credit losses on loans.

The following provides a summary of the risks associated with various segments of the Company's loan portfolio, which are factors management regularly considers when evaluating the adequacy of the allowance:

Commercial

Commercial loans primarily rely on the identified cash flows of the borrower for repayment and secondarily on the value of underlying collateral provided by the borrower. However, the cash flows of the borrowers may not be as expected and the collateral securing these loans may vary in value. Most commercial loans are secured by the assets being financed or on other business assets such as accounts receivable, inventory or equipment and may incorporate a personal guarantee; however, some loans may be unsecured. Included in commercial loans are \$1.2 million of PPP loans at December 31, 2022 and \$88.7 million at December 31, 2021. No allowance for credit losses has been recorded for PPP loans as they are fully guaranteed by the SBA at December 31, 2022 and December 31, 2021.

CRE

CRE loans rely primarily on the cash flows of the properties securing the loan and secondarily on the value of the property that is securing the loan. CRE loans comprise two segments differentiated by owner occupied CRE and non-owner CRE. Owner occupied CRE loans are secured by commercial properties that are at least 50% occupied by the borrower or borrower affiliate. Non-owner occupied CRE loans are secured by commercial properties that are less than 50% occupied by the borrower or borrower affiliate. CRE loans may be adversely affected by conditions in the real estate markets or in the general economy.

Land and Construction

Land and construction loans are generally based on estimates of costs and value associated with the complete project. Construction loans usually involve the disbursement of funds with repayment substantially dependent on the success of the completion of the project. Sources of repayment for these loans may be permanent loans from HBC or other lenders, or proceeds from the sales of the completed project. These loans are monitored by on-site inspections and are considered to have higher risk than other real estate loans due to the final repayment dependent on numerous factors including general economic conditions.

Home Equity

Home equity loans are secured by 1-4 family residences that are generally owner occupied. Repayment of these loans depends primarily on the personal income of the borrower and secondarily on the value of the property securing the loan which can be impacted by changes in economic conditions such as the unemployment rate and property values.

Multifamily

Multifamily loans are loans on residential properties with five or more units. These loans rely primarily on the cash flows of the properties securing the loan for repayment and secondarily on the value of

the properties securing the loan. The cash flows of these borrowers can fluctuate along with the values of the underlying property depending on general economic conditions.

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Residential Mortgages

Residential mortgage loans are secured by 1-4 family residences which are generally owner-occupied. Repayment of these loans depends primarily on the personal income of the borrower and secondarily by the value of the property securing the loan which can be impacted by changes in economic conditions such as the unemployment rate and property values.

Consumer and Other

Consumer and other loans are secured by personal property or are unsecured and rely primarily on the income of the borrower for repayment and secondarily on the collateral value for secured loans. Borrower income and collateral value can vary dependent on economic conditions.

Allocation of Allowance for Credit Losses on Loans

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

On an ongoing basis, we have engaged an outside firm to perform independent credit reviews of our loan portfolio. The Federal Reserve Board and the California Department of Financial Protection and Innovation (“DFPI”) also review the allowance for credit losses on loans as an integral part of the examination process. Based on information currently available, management believes that the allowance for credit losses on loans 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 further. Also, any weakness of a prolonged nature in the technology industry would have a negative impact on the local market. The effect of such events, although uncertain at this time, could result in an increase in the level of nonperforming loans and increased loan losses, which could adversely affect the Company’s future growth and profitability. No assurance of the ultimate level of credit losses can be given with any certainty.

Changes in the allowance for credit losses on loans were as follows for the periods indicated:					
	2022	2021	2020	2019	2018
	(Dollars in thousands)				
Beginning of year balance	\$ 43,290	\$ 44,400	\$ 23,285	\$ 27,848	\$ 19,658
Charge-offs:					
Commercial	(434)	(520)	(1,776)	(6,609)	(2,002)
Consumer and other	—	—	(104)	(14)	(24)
Total charge-offs	(434)	(520)	(1,880)	(6,623)	(2,026)
Recoveries:					
Commercial	427	1,354	998	1,045	2,645
Real estate:					
CRE - owner occupied	15	16	1	—	—
Land and construction	—	884	70	76	114
Home equity	105	93	93	93	36
Consumer and other	3,343	197	30	—	—
Total recoveries	3,890	2,544	1,192	1,214	2,795
Net (charge-offs) recoveries	3,456	2,024	(688)	(5,409)	769
Impact of adopting Topic 326	—	—	8,570	—	—
Provision for credit losses on loans ⁽¹⁾	766	(3,134)	13,233	846	7,421

End of year balance	<u>\$ 47,512</u>	<u>\$ 43,290</u>	<u>\$ 44,400</u>	<u>\$ 23,285</u>	<u>\$ 27,848</u>
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- (1) Provision for credit losses on loans for the year ended December 31, 2022, 2021 and 2020, Provision for loan losses for 2019 and 2018.
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The increase in the allowance for credit losses on loans for the year ended December 31, 2022 was primarily

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attributed to a net increase of \$4.8 million in the reserve for pooled loans, driven by deterioration in forecasted macroeconomic conditions and an increase in the loan portfolio, partially offset by a \$562,000 decrease in specific reserves for individually evaluated loans compared to December 31, 2021.

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

	December 31,									
	2022		2021		2020		2019		2018	
	Allowance	Percent of Loans in each category to total loans	Allowance	Percent of Loans in each category to total loans	Allowance	Percent of Loans in each category to total loans	Allowance	Percent of Loans in each category to total loans	Allowance	Percent of Loans in each category to total loans
Commercial										
Commercial	\$ 6,617	16 %	\$ 8,414	22 %	\$11,587	32 %	\$10,453	24 %	\$17,061	29 %
Real estate:										
CRE - owner occupied	5,751	19 %	7,954	19 %	8,560	21 %	3,825	22 %	2,907	23 %
CRE - non-owner occupied	22,135	32 %	17,125	29 %	16,416	27 %	3,760	30 %	3,456	25 %
Land and construction	2,941	5 %	1,831	5 %	2,509	6 %	2,621	6 %	2,008	7 %
Home equity	666	4 %	864	4 %	1,297	4 %	2,244	6 %	1,609	5 %
Multifamily	3,366	7 %	2,796	7 %	2,804	6 %	57	7 %	374	5 %
Residential mortgages	5,907	16 %	4,132	13 %	943	3 %	243	4 %	317	5 %
Consumer and other	129	1 %	174	1 %	284	1 %	82	1 %	116	1 %
Total	<u>\$47,512</u>	<u>100 %</u>	<u>\$43,290</u>	<u>100 %</u>	<u>\$44,400</u>	<u>100 %</u>	<u>\$23,285</u>	<u>100 %</u>	<u>\$27,848</u>	<u>100 %</u>

The ACLL totaled \$47.5 million, or 1.44% of total loans, at December 31, 2022, compared to \$43.3 million, or 1.40% of total loans at December 31, 2021. The allowance for credit losses on loans to total nonperforming loans increased to 1,959.26% at December 31, 2022, compared to 1,158.11% at December 31, 2021. The Company had net recoveries of (\$3.5) million, or (0.11%) of average loans, for the year ended December 31, 2022, compared to net recoveries of (\$2.0) million, or (0.07%) of average loans, for the year ended December 31, 2021, and net charge-offs of \$688,000, or 0.03% of average loans, for the year ended December 31, 2020.

The following table shows the results of adopting CECL for the year ended December 31, 2022:

Drivers of Change in ACLL Under CECL	(Dollars in thousands)
ACLL at December 31, 2021	\$ 43,290
Portfolio changes during the first quarter of 2022 including net recoveries	(33)
Qualitative and quantitative changes during the first quarter of 2022 including changes in economic forecasts	(469)
ACLL at March 31, 2022	42,788
Portfolio changes during the second quarter of 2022 including net recoveries	1,383
Qualitative and quantitative changes during the second quarter of 2022 including changes in economic forecasts	1,319
ACLL at June 30, 2022	45,490
Portfolio changes during the third quarter of 2022 including net recoveries	2,009
Qualitative and quantitative changes during the third quarter of 2022 including changes in economic forecasts	(578)
ACLL at September 30, 2022	46,921
Portfolio changes during the fourth quarter of 2022 including net recoveries	1,316
Qualitative and quantitative changes during the fourth quarter of 2022 including changes in economic forecasts	(725)
ACLL at December 31, 2022	<u>\$ 47,512</u>

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Leases

On January 1, 2019, the Company adopted Accounting Standards Update (“ASU”) No. 2016-02, Leases (Topic 842). Under the new guidance, the Company recognizes the following for all leases, at the commencement date: (1) a lease liability, which is a lessee’s obligation to make lease payments arising from a lease, measured on a discounted basis; and (2) a right-of-use (“ROU”) asset, which is an asset that represents the lessee’s right to use, or control the use of, a specified asset for the lease term. While the new standard impacts lessors and lessees, the Company is impacted as a lessee of the offices and real estate used for operations. Some of the Company’s lease agreements include options to renew at the Company’s discretion. The extensions are not reasonably certain to be exercised, therefore it was not considered in the calculation of the ROU asset and lease liability. Total assets and liabilities at December 31, 2022 and December 31, 2021 included \$33.0 million and \$34.9 million, respectively, of right-of-use assets, included in other assets, and lease liabilities, included in other liabilities, related to non-cancelable operating lease agreements for office space. See Note 7 to the consolidated financial statements.

Deposits

The composition and cost of the Company’s deposit base are important components in analyzing the Company’s net interest margin and balance sheet liquidity characteristics, both of which are discussed in greater detail in other sections in this report. The Company’s liquidity is impacted by the volatility of deposits from the propensity of that money to leave the institution for rate-related or other reasons. Deposits can be adversely affected if economic conditions weaken in California, and the Company’s market area in particular. Potentially, the most volatile deposits in a financial institution are jumbo certificates of deposit, meaning time deposits with balances that equal or exceed \$250,000, as customers with balances of that magnitude are typically more rate-sensitive than customers with smaller balances.

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

	December 31, 2022		December 31, 2021	
	Balance	% to Total	Balance	% to Total
Demand, noninterest-bearing	\$ 1,736,722	40 %	\$ 1,903,768	40 %
Demand, interest-bearing	1,196,427	27 %	1,308,114	27 %
Savings and money market	1,285,444	29 %	1,375,825	29 %
Time deposits — under \$250	32,445	1 %	38,734	1 %
Time deposits — \$250 and over	108,192	2 %	94,700	2 %
CDARS — interest-bearing demand, money market and time deposits	30,374	1 %	38,271	1 %
Total deposits	\$ 4,389,604	100 %	\$ 4,759,412	100 %

The Company obtains deposits from a cross-section of the communities it serves. The Company’s business is not generally seasonal in nature. Public funds were less than 1% of deposits at December 31, 2022 and December 31, 2021.

Total deposits decreased (\$369.8) million, or (8%), to \$4.390 billion at December 31, 2022, compared to \$4.759 billion at December 31, 2021. Deposits, excluding all time deposits and CDARS deposits, decreased (\$369.1) million, or 8%, to \$4.219 billion at December 31, 2022, compared to \$4.588 billion at December 31, 2021.

The decline in deposits was primarily related to the decrease in balances (of approximately \$170 million) from two large depositors who had temporary high balances in 2021. Additional declines in deposits

were related to the decrease in balances from the distribution of proceeds from the sale of client businesses and real estate, and to a lesser extent, clients moving funds to seek higher rates.

Off-balance sheet deposits increased \$9.4 million, or 4%, to \$254.4 million at December 31, 2022, compared to \$245.0 million at December 31, 2021.

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At December 31, 2022, the \$33.4 million CDARS deposits were comprised of \$26.0 million of interest-bearing demand deposits, \$1.0 million of money market accounts and \$6.4 million of time deposits. At December 31, 2021, the \$38.3 million CDARS deposits were comprised of \$38.3 million of interest-bearing demand deposits, \$1.0 million of money market accounts and \$6.4 million of time deposits.

The following table indicates the contractual maturity schedule of the Company's uninsured time deposits in excess of \$250,000 as of December 31, 2022:

	<u>Balance</u> (Dollars in thousands)	<u>% of Total</u>
Three months or less	\$ 21,408	29 %
Over three months through six months	17,545	24 %
Over six months through twelve months	29,658	40 %
Over twelve months	5,582	7 %
Total	\$ 74,193	100 %

The Company focuses primarily on providing and servicing business deposit accounts that are frequently over \$250,000 in average balance per account. As a result, certain types of business clients that the Company serves typically carry average deposits in excess of \$250,000. The account activity for some account types and client types necessitates appropriate liquidity management practices by the Company to ensure its ability to fund deposit withdrawals.

The contractual maturity of total deposits at December 31, 2022, are as follows:

	<u>Less Than One Year</u>	<u>One to Three Years</u>	<u>Three to Five Years</u>	<u>After Five Years</u>	<u>Total</u>
	(Dollars in thousands)				
Deposits(1)	\$ 4,379,162	\$ 9,796	\$ 366	\$ 280	\$ 4,389,604

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

Return on Equity and Assets

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

	<u>Year Ended December 31,</u>		
	<u>2022</u>	<u>2021</u>	<u>2020</u>
Return on average assets	1.23 %	0.92 %	0.80 %
Return on average tangible assets	1.27 %	0.96 %	0.83 %
Return on average equity	10.95 %	8.15 %	6.12 %
Return on average tangible common equity	15.57 %	11.86 %	9.04 %
Average equity to average assets ratio	11.25 %	11.33 %	13.00 %

Liquidity and Asset/Liability Management

Liquidity refers to the Company's ability to maintain cash flows sufficient to fund operations and to meet obligations and other commitments in a timely and cost effective fashion. At various times the Company requires funds to meet short-term cash requirements brought about by loan growth or deposit outflows, the purchase of assets, or liability repayments. An integral part of the Company's ability to manage its liquidity position appropriately is the Company's large base of core deposits, which are generated by offering traditional banking services in its service area and which have historically been a stable source of funds. To manage liquidity needs properly, cash inflows must be timed to coincide with anticipated outflows or sufficient liquidity resources must be available to meet varying demands. The Company manages liquidity to be able to meet unexpected sudden changes in levels of its assets or deposit liabilities without maintaining

excessive amounts of balance sheet liquidity. Excess balance sheet liquidity can negatively impact the Company's interest

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margin. In order to meet short-term liquidity needs the Company may utilize overnight Federal funds purchase arrangements and other borrowing arrangements with correspondent banks, solicit brokered deposits if cost effective deposits are not available from local sources, and maintain collateralized lines of credit with the FHLB and FRB. In addition, the Company can raise cash for temporary needs by selling securities under agreements to repurchase and selling securities available-for-sale.

One of the measures of liquidity is our loan to deposit ratio. Our loan to deposit ratio was 75.14% at December 31, 2022, compared to 64.87% at December 31, 2021.

FHLB and FRB Borrowings and Available Lines of Credit

HBC has off-balance sheet liquidity in the form of Federal funds purchase arrangements with correspondent banks, and lines of credit from the FHLB and FRB. The Company can borrow from the FHLB on a short-term (typically overnight) or long-term (over one year) basis. As of December 31, 2022, and December 31, 2021, HBC had no overnight borrowings from the FHLB. HBC had \$254.2 million of loans and \$1.1 million of securities pledged to the FHLB as collateral on a line of credit of \$162.6 million at December 31, 2022, none of which was outstanding.

HBC can also borrow from the FRB's discount window. HBC had approximately \$1.0 billion of loans pledged to the FRB as collateral on an available line of credit of approximately \$676.9 million at December 31, 2022, none of which was outstanding.

HBC had Federal funds purchase arrangements available of \$80.0 million and \$90.0 million at December 31, 2022 and 2021, respectively. There were no Federal funds purchased outstanding at December 31, 2022 and 2021.

The Company has a \$20.0 million line of credit with a correspondent bank, of which none was outstanding at December 31, 2022.

HBC may also utilize securities sold under repurchase agreements to manage our liquidity position. There were no securities sold under agreements to repurchase at December 31, 2022 and 2021.

Capital Resources

The Company uses a variety of measures to evaluate capital adequacy. Management reviews various capital measurements on a regular basis and takes appropriate action to ensure that such measurements are within established internal and external guidelines. The external guidelines, which are issued by the Federal Reserve and the FDIC, establish a risk-adjusted ratio relating capital to different categories of assets and off-balance sheet exposures.

On May 11, 2022, the Company completed a private placement offering of \$40.0 million aggregate principal amount of its 5.00% fixed-to-floating rate subordinated notes due May 15, 2032 ("Sub Debt due 2032"). The Company used the net proceeds of the Sub Debt due 2032 for general corporate purposes, including the repayment on June 1, 2022 of the Company's \$40.0 million aggregate principal amount of 5.25% fixed-to-floating rate subordinated notes due June 1, 2027 ("Sub Debt due 2027"). The Sub Debt due 2032, net of unamortized issuance costs of \$650,000, totaled \$39.4 million at December 31, 2022, and qualifies as Tier 2 capital for the Company under the guidelines established by the Federal Reserve Bank.

On May 26, 2017, the Company completed an underwritten public offering of \$40.0 million aggregate principal amount of its Sub Debt due 2027. The Sub Debt due 2027 had a fixed interest rate of 5.25% per year through June 1, 2022. On June 1, 2022, the Company completed the redemption of all of its outstanding \$40.0 million of Sub Debt due 2027, prior to resetting to a floating rate. The Sub Debt due 2027 was redeemed pursuant to the terms of the Subordinated Indenture, as supplemented by the First Supplemental Indenture, each dated as of May 26, 2017, between the Company and Wilmington Trust, National Association, as Trustee, at the redemption price of 100% of its principal amount, plus accrued and unpaid interest of \$1.1 million.

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The following table summarizes risk based capital, risk weighted assets, and risk based capital ratios of the consolidated Company under the Basel III requirements for the periods indicated:

	December 31, 2022	December 31, 2021	December 31, 2020
	(Dollars in thousands)		
Capital components:			
Common Equity Tier 1 capital	\$ 475,609	\$ 433,488	\$ 410,307
Additional Tier 1 capital	—	—	—
Tier 1 Capital	<u>475,609</u>	<u>433,488</u>	<u>410,307</u>
Tier 2 Capital	79,201	72,721	73,563
Total Capital	<u><u>\$ 554,810</u></u>	<u><u>\$ 506,209</u></u>	<u><u>\$ 483,870</u></u>
Risk-weighted assets	\$ 3,747,246	\$ 3,521,058	\$ 2,924,448
Average assets for capital purposes	\$ 5,196,294	\$ 5,504,834	\$ 4,507,032
Capital ratios:			
Total Capital	14.8 %	14.4 %	16.5 %
Tier 1 Capital	12.7 %	12.3 %	14.0 %
Common equity Tier 1 Capital	12.7 %	12.3 %	14.0 %
Tier 1 Leverage(1)	9.2 %	7.9 %	9.1 %

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- (1) Tier 1 capital divided by quarterly average assets (excluding intangible assets and disallowed deferred tax assets).
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The following table summarizes risk-based capital, risk-weighted assets, and risk-based capital ratios of HBC under the Basel III requirements for the periods indicated:

	December 31, 2022	December 31, 2021	December 31, 2020
	(Dollars in thousands)		
Capital components:			
Common Equity Tier 1 capital	\$ 492,725	\$ 451,586	\$ 428,109
Additional Tier 1 capital	—	—	—
Tier 1 Capital	<u>492,725</u>	<u>451,586</u>	<u>428,109</u>
Tier 2 Capital	39,851	32,796	33,824
Total Capital	<u><u>\$ 532,576</u></u>	<u><u>\$ 484,382</u></u>	<u><u>\$ 461,933</u></u>
Risk-weighted assets	\$ 3,745,725	\$ 3,518,391	\$ 2,922,577
Average assets for capital purposes	\$ 5,194,802	\$ 5,502,185	\$ 4,505,265
Capital ratios:			
Total Capital	14.2 %	13.8 %	15.8 %
Tier 1 Capital	13.2 %	12.8 %	14.6 %
Common Equity Tier 1 Capital	13.2 %	12.8 %	14.6 %
Tier 1 Leverage(1)	9.5 %	8.2 %	9.5 %

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- (1) Tier 1 capital divided by quarterly average assets (excluding intangible assets and disallowed deferred tax assets).
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The following table presents the applicable well-capitalized regulatory guidelines and the standards for minimum capital adequacy requirements under Basel III:

	Minimum Regulatory Requirement(1)	Well-capitalized Financial Institution PCA Regulatory Guidelines
Capital ratios:		
Total Capital	10.5 %	10.0 %
Tier 1 Capital	8.5 %	8.0 %
Common equity Tier 1 Capital	7.0 %	6.5 %
Tier 1 Leverage	4.0 %	5.0 %

(1) Includes 2.5% capital conservation buffer, except the leverage ratio.

The Basel III capital rules introduce a new “capital conservation buffer,” for banking organizations to maintain a common equity Tier 1 ratio more than 2.5% above these minimum risk-weighted asset ratios. The capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions with a ratio of common equity Tier 1 to risk-weighted assets above the minimum but below the capital conservation buffer will face constraints on dividends, equity repurchases and compensation based on the amount of the shortfall.

At December 31, 2022, the Company’s consolidated capital ratio exceeded regulatory guidelines and HBC’s capital ratios exceed the highest regulatory capital requirement of “well-capitalized” under Basel III prompt corrective action provisions. Quantitative measures established by regulation to help ensure capital adequacy require the Company and HBC to maintain minimum amounts and ratios of total risk-based capital, Tier 1 capital, and common equity Tier 1 (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital to average assets (as defined). Management believes that, as of December 31, 2022, December 31, 2021, and December 31, 2020, the Company and HBC met all capital adequacy guidelines to which they were subject. There are no conditions or events since of December 31, 2022, that management believes have changed the categorization of the Company or HBC as well-capitalized.

At December 31, 2022, the Company had total shareholders’ equity of \$632.5 million, compared to \$598.0 million at December 31, 2021. At December 31, 2022, total shareholders’ equity included \$502.9 million in common stock, \$146.4 million in retained earnings, and (\$16.8) million of accumulated other comprehensive loss. The book value per common share was \$10.39 at December 31, 2022, compared to \$9.91 at December 31, 2021. The tangible book value per common share was \$7.46 at December 31, 2022, compared to \$6.91 at December 31, 2021.

The following table reflects the components of accumulated other comprehensive loss, net of taxes, for the periods indicated:

Accumulated Other Comprehensive Loss	December 31, 2022	December 31, 2021
	(Dollars in thousands)	
Unrealized (loss) gain on securities available-for-sale	\$ (11,506)	\$ 1,991
Split dollar insurance contracts liability	(3,091)	(5,480)
Supplemental executive retirement plan liability	(2,371)	(7,669)
Unrealized gain on interest-only strip from SBA loans	112	162
Total accumulated other comprehensive loss	\$ (16,856)	\$ (10,996)

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Selected Financial Data

The following table presents a summary of selected financial information that should be read in conjunction with the Company's Consolidated Financial Statements and notes thereto following Item 15 — *Exhibits and Financial Statement Schedules*.

SELECTED FINANCIAL DATA

	AT OR FOR YEAR ENDED DECEMBER 31,				
	2022	2021	2020	2019	2018
INCOME STATEMENT DATA:					
Interest income	\$ 188,828	\$ 153,256	\$ 150,471	\$ 142,659	\$ 129,845
Interest expense	8,948	7,131	8,581	10,847	7,822
Net interest income before provision for credit losses on loans(1)	179,880	146,125	141,890	131,812	122,023
Provision for (recapture of)credit losses on loans(1)	766	(3,134)	13,233	846	7,421
Net interest income after provision for credit losses on loans(1)	179,114	149,259	128,657	130,966	114,602
Noninterest income	10,111	9,688	9,922	10,244	9,574
Noninterest expense	94,859	93,077	89,511	84,898	75,521
Income before income taxes	94,366	65,870	49,068	56,312	48,655
Income tax expense	27,811	18,170	13,769	15,851	13,324
Net income	<u>66,555</u>	<u>47,700</u>	<u>35,299</u>	<u>40,461</u>	<u>35,331</u>
PER COMMON SHARE DATA:					
Basic net income(2)	\$ 1.10	\$ 0.79	\$ 0.59	\$ 0.87	\$ 0.85
Diluted net income(3)	\$ 1.09	\$ 0.79	\$ 0.59	\$ 0.84	\$ 0.84
Book value per common share	\$ 10.39	\$ 9.91	\$ 9.64	\$ 9.71	\$ 8.49
Tangible book value per common share	\$ 7.46	\$ 6.91	\$ 6.57	\$ 6.55	\$ 6.28
Dividend payout ratio	47.32 %	65.56 %	88.04 %	56.16 %	52.26 %
Weighted average number of shares outstanding — basic	60,602,962	60,133,821	59,478,343	46,684,384	41,469,211
Weighted average number of shares outstanding — diluted	61,090,290	60,689,062	60,169,139	47,906,229	42,182,939
Common shares outstanding at period end	60,852,723	60,339,837	59,917,457	59,368,156	43,288,750
BALANCE SHEET DATA:					
Securities (available-for sale and held-to-maturity)	\$ 1,204,586	\$ 760,649	\$ 533,163	\$ 771,385	\$ 836,241
Net loans	\$ 3,251,038	\$ 3,044,036	\$ 2,574,861	\$ 2,510,559	\$ 1,858,557
Allowance for credit losses on loans(4)	\$ 47,512	\$ 43,290	\$ 44,400	\$ 23,285	\$ 27,848
Goodwill and other intangible assets	\$ 178,664	\$ 181,299	\$ 184,295	\$ 187,835	\$ 95,760
Total assets	\$ 5,157,580	\$ 5,499,409	\$ 4,634,114	\$ 4,109,463	\$ 3,096,562
Total deposits	\$ 4,389,604	\$ 4,759,412	\$ 3,914,486	\$ 3,414,768	\$ 2,637,532
Subordinated debt, net of issuance costs	\$ 39,350	\$ 39,925	\$ 39,740	\$ 39,554	\$ 39,369
Short-term borrowings	\$ —	\$ —	\$ —	\$ 328	\$ —
Total shareholders' equity	<u>\$ 632,456</u>	<u>\$ 598,028</u>	<u>\$ 577,889</u>	<u>\$ 576,708</u>	<u>\$ 367,466</u>
SELECTED PERFORMANCE RATIOS:(5)					
Return on average assets	1.23 %	0.92 %	0.80 %	1.21 %	1.16 %
Return on average tangible assets	1.27 %	0.96 %	0.83 %	1.25 %	1.19 %
Return on average equity	10.95 %	8.15 %	6.12 %	9.51 %	10.79 %
Return on average tangible common equity	15.57 %	11.86 %	9.04 %	13.09 %	14.41 %
Net interest margin (fully tax equivalent)	3.57 %	3.05 %	3.50 %	4.28 %	4.31 %
Efficiency ratio (6)	49.93 %	59.74 %	58.96 %	59.76 %	57.39 %
Average net loans (excludes loans held-for-sale) as a percentage of average deposits	66.10 %	61.39 %	69.58 %	69.65 %	67.35 %
Average total shareholders' equity as a percentage of average total assets	11.25 %	11.33 %	13.00 %	12.69 %	10.72 %
SELECTED ASSET QUALITY DATA:(7)					
Net charge-offs (recoveries) to average loans	(0.11)%	(0.07)%	0.03 %	0.27 %	(0.04)%
Allowance for credit losses on loans to total loans (4)	1.44 %	1.40 %	1.70 %	0.92 %	1.48 %
Nonperforming loans to total loans	0.07 %	0.12 %	0.30 %	0.39 %	0.79 %
Nonperforming assets	\$ 2,425	\$ 3,738	\$ 7,869	\$ 9,828	\$ 14,887
HERITAGE COMMERCE CORP CAPITAL RATIOS:					
Total capital ratio	14.8 %	14.4 %	16.5 %	14.6 %	15.0 %
Tier 1 capital ratio	12.7 %	12.3 %	14.0 %	12.5 %	12.0 %
Common equity Tier 1 capital ratio	12.7 %	12.3 %	14.0 %	12.5 %	12.0 %
Tier 1 leverage ratio	9.2 %	7.9 %	9.1 %	9.7 %	8.9 %

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Notes:

- (1) Provision for (recapture of) credit losses on loans for the years ended December 31, 2022, 2021 and 2020.
Provision for loan losses for previous years.
 - (2) Represents distributed and undistributed earnings allocated to common shareholders, divided by the average number of shares of common stock outstanding for the respective period. See Note 16 to the consolidated financial statements.
 - (3) Represents distributed and undistributed earnings allocated to common shareholders, divided by the average number of shares of common stock and common stock-equivalents outstanding for the respective period. See Note 16 to the consolidated financial statements.
 - (4) Allowance for credit losses on loans at December 31, 2022, 2021, and 2020. Allowance for loan losses for previous years.
 - (5) Average balances used in this table and throughout this Annual Report are based on daily averages.
 - (6) The efficiency ratio is calculated by dividing noninterest expenses by the sum of net interest income before provision for credit losses on loans and noninterest income.
 - (7) Average loans and total loans exclude loans held-for-sale.
-

Quarterly Financial Data (Unaudited)

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

	Quarter Ended			
	12/31/2022	9/30/2022	6/30/2022	3/31/2022
	(Dollars in thousands, except per share amounts)			
Interest income	\$ 55,192	\$ 50,174	\$ 43,556	\$ 39,906
Interest expense	3,453	2,133	1,677	1,685
Net interest income	51,739	48,041	41,879	38,221
Provision for (recapture of) credit losses on loans	508	1,006	(181)	(567)
Net interest income after provision for credit losses on loans	51,231	47,035	42,060	38,788
Noninterest income	2,772	2,781	2,098	2,460
Noninterest expense	24,518	23,899	23,190	23,252
Income before income taxes	29,485	25,917	20,968	17,996
Income tax expense	8,686	7,848	6,147	5,130
Net income	\$ 20,799	\$ 18,069	\$ 14,821	\$ 12,866
Earnings per common share				
Basic	\$ 0.34	\$ 0.30	\$ 0.24	\$ 0.21
Diluted	\$ 0.34	\$ 0.30	\$ 0.24	\$ 0.21

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	Quarter Ended			
	12/31/2021	9/30/2021	6/30/2021	3/31/2021
	(Dollars in thousands, except per share amounts)			
Interest income	\$ 39,956	\$ 39,907	\$ 36,632	\$ 36,761
Interest expense	<u>1,847</u>	<u>1,725</u>	<u>1,756</u>	<u>1,803</u>
Net interest income	38,109	38,182	34,876	34,958
Provision for (recapture of) credit losses on loans	<u>(615)</u>	<u>(514)</u>	<u>(493)</u>	<u>(1,512)</u>
Net interest income after provision for credit losses on loans	38,724	38,686	35,369	36,470
Noninterest income	2,810	2,408	2,169	2,301
Noninterest expense	<u>22,227</u>	<u>21,831</u>	<u>25,775</u>	<u>23,244</u>
Income before income taxes	19,307	19,273	11,763	15,527
Income tax expense	<u>5,342</u>	<u>5,555</u>	<u>2,950</u>	<u>4,323</u>
Net income	<u>\$ 13,965</u>	<u>\$ 13,718</u>	<u>\$ 8,813</u>	<u>\$ 11,204</u>
Earnings per common share				
Basic	\$ 0.23	\$ 0.23	\$ 0.15	\$ 0.19
Diluted	\$ 0.23	\$ 0.23	\$ 0.15	\$ 0.19

Market Risk

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

Interest Rate Management

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

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

The planning of asset and liability maturities is an integral part of the management of an institution's net interest margin. To the extent maturities of assets and liabilities do not match in a changing interest rate environment, the net interest margin may change over time. Even with perfectly matched repricing of assets

and liabilities, risks remain in the form of prepayment of loans or securities or in the form of delays in the adjustment of rates of interest applying to either earning assets with floating rates or to interest bearing liabilities. The Company has generally been able to control its exposure to changing interest rates by maintaining primarily floating interest rate loans and a majority of its time certificates with relatively short maturities.

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

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factors, an interest sensitivity GAP report may not provide a complete assessment of the exposure to changes in interest rates.

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

The following table sets forth the estimated changes in the Company's annual net interest income that would result from the designated instantaneous parallel shift in interest rates noted, as of December 31, 2022. Computations of prospective effects of hypothetical interest rate changes are based on numerous assumptions including relative levels of market interest rates, loan prepayments and deposit decay, and should not be relied upon as indicative of actual results.

Change in Interest Rates (basis points)	Increase/(Decrease) in Estimated Net Interest Income ⁽¹⁾	
	Amount (Dollars in thousands)	Percent
+400	\$ 20,274	9.4 %
+300	\$ 15,183	7.1 %
+200	\$ 10,119	4.7 %
+100	\$ 5,090	2.4 %
0	—	—
-100	\$ (10,250)	(4.8)%
-200	\$ (24,753)	(11.5)%
-300	\$ (39,082)	(18.2)%
-400	\$ (52,586)	(24.5)%

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

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

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

As a financial institution, the Company's primary component of market risk is interest rate volatility. Fluctuations in interest rates will ultimately impact both the level of income and expense recorded on most of the Company's assets

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and liabilities and the market value of all interest-earning assets, other than those which have a short term to maturity. Based upon the nature of the Company's operations, the Company is not subject to foreign exchange or commodity price risk. The Company has no market risk sensitive instruments held for trading purposes. As of December 31, 2022, the Company did not use interest rate derivatives to hedge its interest rate risk.

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

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The financial statements and report of the Independent Registered Public Accounting Firm are set forth on pages 94 through 145.

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

None.

ITEM 9A. CONTROLS AND PROCEDURES

Disclosure Control and Procedures

The Company has carried out an evaluation, under the supervision and with the participation of the Company's management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of December 31, 2022. As defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), disclosure controls and procedures are controls and procedures designed to reasonably assure that information required to be disclosed in our reports filed or submitted under the Exchange Act are recorded, processed, summarized and reported on a timely basis. Disclosure controls are also designed to reasonably assure that such information is accumulated and communicated to our management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. Based upon their evaluation, our Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls were effective as of December 31, 2022, the period covered by this report.

Management's Annual Report on Internal Control over Financial Reporting

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

- Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of a company;
- Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of a company are being made only in accordance with authorizations of management and the board of directors of the company; and
- Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of a company's assets that could have a material effect on its financial statements.

Because of the inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls

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may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

The Company's management has used the criteria established in the 2013 *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") to evaluate the effectiveness of the Company's internal control over financial reporting. Management has selected the COSO framework for its evaluation as it is a control framework recognized by the SEC and the Public Company Accounting Oversight Board, that is free from bias, permits reasonably consistent qualitative and quantitative measurement of the Company's internal controls, is sufficiently complete so that relevant controls are not omitted and is relevant to an evaluation of internal controls over financial reporting.

Based on our assessment, management has concluded that our internal control over financial reporting, based on criteria established in the 2013 *Internal Control — Integrated Framework* issued by COSO was effective as of December 31, 2022.

The independent registered public accounting firm of Crowe LLP, as auditors of our consolidated financial statements, has issued an audit report on the effectiveness of the Company's internal control over financial reporting based on criteria established in the 2013 "*Internal Control — Integrated Framework*," issued by COSO.

Inherent Limitations on Effectiveness of Controls

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

Changes in Internal Control over Financial Reporting

There was no change in our internal control over financial reporting that occurred during the year ended December 31, 2022 that has materially affected or is reasonably likely to materially affect our internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

Not applicable.

ITEM 9C. DISCLOSURE REGARDING FOREIGN JURISDICTIONS THAT PREVENT INSPECTIONS

Not applicable.

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PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF REGISTRANT

Information required by this item will be contained in our Definitive Proxy Statement for our 2023 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A with the Securities and Exchange Commission within 120 days of December 31, 2022. Such information is incorporated herein by reference.

We have adopted a code of ethics that applies to our Chief Executive Officer, Chief Financial Officer, and to our other principal financial officers, and other senior management personnel, as designated. The code of ethics is available at the Governance Documents section of our website at www.heritagecommercecorp.com. We intend to disclose future amendments to, or waivers from, certain provisions of our code of ethics on the above website.

ITEM 11. EXECUTIVE COMPENSATION

Information required by this item will be contained in our Definitive Proxy Statement for our 2023 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A with the Securities and Exchange Commission within 120 days of December 31, 2022. Such information is incorporated herein by reference.

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

(a) Securities Authorized for Issuance Under Equity Compensation Plans

The following table provides information as of December 31, 2022 regarding equity compensation plans under which equity securities of the Company were authorized for issuance:

	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	2,527,173 ⁽¹⁾ \$	10.44	1,475,594 ⁽²⁾
Equity compensation plans not approved by security holders	N/A	N/A	N/A

⁽¹⁾ Consists of 42,418 options to acquire shares under the Company's Amended and Restated 2004 Equity Plan, 1,989,683 options to acquire shares under the Company's 2013 Equity Incentive Plan, and the aggregate amount of 495,072 stock options assumed from the Presidio stock option and equity incentive plans.

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

(b) Information required by this item will be contained in our Definitive Proxy Statement for our 2023 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A with the Securities and Exchange Commission within 120 days of December 31, 2022. Such information is incorporated herein by reference.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE

Information required by this item will be contained in our Definitive Proxy Statement for our 2023 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A with the Securities and Exchange

Commission within 120 days of December 31, 2022. Such information is incorporated herein by reference.

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ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

Information required by this item will be contained in our Definitive Proxy Statement for our 2023 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A with the Securities and Exchange Commission within 120 days of December 31, 2022. Such information is incorporated herein by reference.

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(1) FINANCIAL STATEMENTS

The Financial Statements of the Company and the Report of Independent Registered Public Accounting Firm are set forth on pages 94 through 145.

(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.

(3) EXHIBITS

The exhibits listed below are filed or incorporated by reference as part of this Annual Report on Form 10-K.

Exhibit Number	Description
2.1	<u>Agreement and Plan of Merger and Reorganization, dated April 23, 2015, by and among Heritage Commerce Corp, Heritage Bank of Commerce and Focus Business Bank (incorporated by reference from the Registrant's Current Report on Form 8-K filed on April 23, 2015)</u>
2.2	<u>Agreement and Plan of Merger and Reorganization, dated December 20, 2017, by and among Heritage Commerce Corp, Heritage Bank of Commerce and Tri-Valley Bank (incorporated by reference from the Registrant's Current Report on Form 8-K filed on December 20, 2017)</u>
2.3	<u>Agreement and Plan of Merger and Reorganization, dated January 10, 2018, by and among Heritage Commerce Corp, Heritage Bank of Commerce, AT Bancorp and United American Bank (incorporated by reference from the Registrant's Current Report on Form 8-K filed on January 10, 2018)</u>
2.4	<u>Agreement and Plan of Merger, dated May 16, 2019, by and among Heritage Commerce Corp, Heritage Bank of Commerce, and Presidio Bank (incorporated by reference from the Registrant's Current Report on Form 8-K filed on May 17, 2019)</u>
3.1	<u>Restated Articles of Incorporation of Heritage Commerce Corp (incorporated by reference from the Registrant's Annual Report on Form 10-K filed on March 16, 2009)</u>
3.2	<u>Certificate of Amendment of Articles of Incorporation of Heritage Commerce Corp, as filed with the California Secretary of State on June 1, 2010 (incorporated by reference from the Registration Statement on Form S-1 filed July 23, 2010)</u>
3.3	<u>Bylaws, as amended, of Heritage Commerce Corp (incorporated by reference from the Registrant's Current Report Form 8-K filed June 28, 2013)</u>
3.4	<u>Certificate of Amendment of Articles of Incorporation of Heritage Commerce Corp, as filed with the Secretary of State on August 29, 2019 (incorporated by reference from Registrant's Quarterly Report on Form 10-Q filed November 11, 2019)</u>
3.5	<u>Certificate of Determination of the Articles of Incorporation (Revocation of Series A Preferred), as filed with the Secretary of State on April 5, 2019 (incorporated by reference from the Registrant's Annual Report on Form 10-K filed on March 11, 2020)</u>
3.6	<u>Certificate of Determination of the Articles of Incorporation (Revocation of Series B Preferred), as filed with the Secretary of State on April 5, 2019 (incorporated by reference from</u>

[the Registrant's Annual Report on Form 10-K filed on March 11, 2020\)](#)

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Exhibit Number	Description
3.7	<u>Certificate of Determination of the Articles of Incorporation (Revocation of Series C Preferred), as filed with the Secretary of State on April 5, 2019 (incorporated by reference from the Registrant's Annual Report on Form 10-K filed on March 11, 2020)</u>
4.1	<u>Form of 5.25% Fixed-to-Floating Rate Subordinated Notes due 2027 (included in Exhibit 4.2) (incorporated by reference from the Registrant's Current Report on Form 8-K filed on May 26, 2017)</u>
4.2	<u>Description of Securities Registered under Section 12 of the Securities Exchange Act of 1934 (incorporated herein by reference from the Registrant's Annual Report on Form 10-K filed on March 11, 2020)</u>
*10.1	<u>Heritage Commerce Corp Management Cash Incentive Bonus Plan (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed January 28, 2022)</u>
*10.2	<u>Amended and Restated 2004 Equity Plan (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed June 2, 2009)</u>
*10.3	<u>Non-qualified Deferred Compensation Plan (incorporated herein by reference from the Registrant's Annual Report on Form 10-K filed March 31, 2005)</u>
*10.4	<u>Amended and Restated Employment Agreement with Lawrence McGovern, dated July 21, 2011 (incorporated herein by reference from the Registrant's Current Report on Form 8 K filed July 21, 2011)</u>
*10.5	<u>Employment Agreement with Margo Butsch, dated June 26, 2017 (incorporated by reference from the Registrant's Current Report on Form 8-K filed June 26, 2017)</u>
*10.6	<u>Employment Agreement with Robertson Clay Jones, dated September 15, 2022 (incorporated by reference from the Registrant's Current Report on Form 8-K filed September 19, 2022)</u>
*10.7	<u>Employment Agreement with Robertson Clay Jones, effective October 11, 2019 (incorporated by reference from the Registrant's Annual Report on Form 10-K filed March 11, 2020)</u>
*10.8	<u>Employment Agreement with Jan Coonley, effective July 12, 2022</u>
*10.9	<u>Employment Agreement with Debra K. Reuter, effective July 23, 2015</u>
*10.10	<u>Form of Stock Option Agreement For Amended and Restated 2004 Equity Plan (incorporated by reference from the Registrant's Annual Report on Form 10-K filed March 9, 2012)</u>
*10.11	<u>Form of Restricted Stock Agreement For Amended and Restated 2004 Equity Plan (incorporated by reference from the Registrant's Annual Report on Form 10-K filed March 9, 2012)</u>
*10.12	<u>2013 Equity Incentive Plan (incorporated by reference from the Registrant's Registration Statement on Form S-8 filed July 15, 2013)</u>
*10.13	<u>Amendment No. 1 to Heritage Commerce Corp 2013 Equity Incentive Plan, dated May 25, 2017 (incorporated by reference from the Registrant's Proxy Statement, dated April 19, 2017, Appendix A, filed April 19, 2017)</u>
*10.14	<u>Amendment No. 2 to Heritage Commerce Corp 2013 Equity Incentive Plan, dated May 21, 2020 (incorporated by reference from the Registrant's Proxy Statement, dated April 15, 2020, Appendix A, filed April 15, 2020)</u>
*10.15	<u>Form of Restricted Stock Agreement for 2013 Equity Incentive Plan (incorporated by reference from the Registrant's Registration Statement on Form S-8 filed July 15, 2013)</u>
*10.16	<u>Form of Stock Option Agreement for 2013 Equity Incentive Plan (incorporated by reference from the Registrant's Registration Statement on Form S-8 filed July 15, 2013)</u>
*10.17	<u>Form of Restricted Stock Unit Agreement (serviced-based) for 2013 Equity Incentive Plan</u>
*10.18	<u>Form of Restricted Stock Unit Agreement (performance-based) for 2013 Equity Incentive Plan</u>
*10.19	<u>2005 Amended and Restated Heritage Commerce Corp Supplemental Retirement Plan (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed September 30, 2008)</u>
*10.20	<u>Form of Endorsement Method Split Dollar Plan Agreement for Executive Officers (incorporated herein by reference from the Registrant's Annual Report on Form 10-K filed March 17, 2008)</u>
*10.21	<u>Form of Endorsement Method Split Dollar Plan Agreement for Directors (incorporated herein by reference from the Registrant's Annual Report on Form 10-K filed March 17, 2008)</u>
*10.22	<u>First Amended and Restated Director Compensation Benefits Agreement dated December 29, 2008 between Jack Conner and the Company (incorporated herein by reference from the</u>

[Registrant's Current Report on Form 8-K filed January 2, 2009\)](#)

*10.23 [First Amended and Restated Director Compensation Benefits Agreement dated December 29, 2008 between Frank Bisceglia and the Company \(incorporated herein by reference from the Registrant's Current Report on Form 8-K filed January 2, 2009\)](#)

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Exhibit Number	Description
*10.24	First Amended and Restated Director Compensation Benefits Agreement dated December 29, 2008 between Robert Moles and the Company (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed January 2, 2009)
*10.25	First Amended and Restated Director Compensation Benefits Agreement dated December 29, 2008 between Ranson Webster and the Company (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed January 2, 2009)
*10.26	Employment Agreement with Walter T. Kaczmareck, dated April 5, 2021 (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed April 8, 2021)
10.27	Form of Indemnification Agreement between the Registrant and its directors and executive officers (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed December 23, 2009)
10.28	Stock Purchase Agreement, between Heritage Bank of Commerce, BVF Acquisition Corp and the stockholders named therein dated October 8, 2014 (incorporated herein from the Registrant's Current Report on Form 8-K, as filed October 9, 2014)
*10.29	Presidio Bank Amended and Restated 2006 Stock Options Plan (incorporated herein by reference from the Registrant's Statement on Form S-8 filed October 15, 2019)
*10.30	Presidio Bank 2016 Equity Incentive Plan (incorporated herein by reference from the Registrant's Statement on Form S-8 filed October 15, 2019)
21.1	Subsidiaries of the Registrant (incorporated herein from the Registrant's 2016 Annual Report on Form 10-K, as filed March 3, 2017)
23.1	Consent of Crowe LLP
31.1	Certification of Registrant's Chief Executive Officer Pursuant to Section 302 of the Sarbanes Oxley Act of 2002
31.2	Certification of Registrant's Chief Financial Officer Pursuant to Section 302 of the Sarbanes Oxley Act of 2002
32.1	Certification of Registrant's Chief Executive Officer Pursuant to 18 U.S.C. Section 1350
32.2	Certification of Registrant's Chief Financial Officer Pursuant to 18 U.S.C. Section 1350
101.INS	Inline XBRL Instance Document, filed herewith
101.SCH	XBRL Taxonomy Extension Schema Document, filed herewith
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document, filed herewith
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document, filed herewith
101.LAB	XBRL Taxonomy Extension Label Linkbase Document, filed herewith
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document, filed herewith
104	Cover Page Interactive Data (formatted as inline XBRL)

* Management contract or compensatory plan or arrangement.

ITEM 16. FORM 10-K SUMMARY

Not applicable.

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SIGNATURE

HERITAGE COMMERCE CORP

BY: /s/ ROBERTSON CLAY JONES

Robertson Clay Jones

Chief Executive Officer

DATE: March 8, 2023

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

Signature	Title	Date
<u>/s/ JULIANNE M. BIAGINI-KOMAS</u> Julianne M. Biagini-Komas	Director	March 8, 2023
<u>/s/ BRUCE H. CABRAL</u> Bruce H. Cabral	Director	March 8, 2023
<u>/s/ JACK W. CONNER</u> Jack W. Conner	Director and Chairman of the Board	March 8, 2023
<u>/s/ JASON DINAPOLI</u> Jason DiNapoli	Director	March 8, 2023
<u>/s/ STEPHEN G. HEITEL</u> Stephen G. Heitel	Director	March 8, 2023
<u>/s/ KAMRAN F. HUSAIN</u> Kamran F. Husain	Director	March 8, 2023
<u>/s/ ROBERTSON CLAY JONES</u> Robertson Clay Jones	Director and Chief Executive Officer (Principal Executive Officer)	March 8, 2023
<u>/s/ WALTER T. KACZMAREK</u> Walter T. Kaczmarek	Director	March 8, 2023
<u>/s/ LAWRENCE D. MCGOVERN</u> Lawrence D. McGovern	Executive Vice President and Chief Financial Officer (Principal Financial and Accounting Officer)	March 8, 2023
<u>/s/ ROBERT T. MOLES</u> Robert T. Moles	Director	March 8, 2023
<u>/s/ MARINA H. PARK SUTTON</u> Marina H. Park Sutton	Director	March 8, 2023
<u>/s/ LAURA RODEN</u> Laura Roden	Director	March 8, 2023

/s/ RANSON W. WEBSTER
Ranson W. Webster

Director

March 8,
2023

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HERITAGE COMMERCE CORP
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<u>Consolidated Statements of Income for the years ended December 31, 2022, 2021 and 2020</u>	100
<u>Consolidated Statements of Comprehensive Income for the years ended December 31, 2022, 2021 and 2020</u>	101
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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Shareholders and the Board
of Directors of Heritage Commerce Corp
San Jose, California

Opinions on the Financial Statements and Internal Control over Financial Reporting

We have audited the accompanying consolidated balance sheets of Heritage Commerce Corp (the "Company") as of December 31, 2022 and 2021, the related consolidated statements of income, comprehensive income, changes in shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2022, and the related notes (collectively referred to as the "financial statements"). We also have audited the Company's internal control over financial reporting as of December 31, 2022, based on criteria established in Internal Control – Integrated Framework: (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2022 and 2021, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2022 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2022, based on criteria established in Internal Control – Integrated Framework: (2013) issued by COSO.

Basis for Opinions

The Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Annual Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's financial statements and an opinion on the Company's internal control over financial reporting based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud, and whether effective internal control over financial reporting was maintained in all material respects.

Our audits of the financial statements included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

Definition and Limitations of Internal Control Over Financial Reporting

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial

reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the

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transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

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

Critical Audit Matter

The critical audit matter communicated below is a matter arising from the current period audit of the financial statements that was communicated or required to be communicated to the audit committee and that: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved our especially challenging, subjective, or complex judgments. The communication of the critical audit matter does not alter in any way our opinion on the financial statements, taken as a whole, and we are not, by communicating the critical audit matter below, providing a separate opinion on the critical audit matter or on the accounts or disclosures to which it relates.

Allowance for Credit Losses on Loans – Economic Forecasts and Qualitative Adjustments

As described in Notes 1 and 4 to the consolidated financial statements, the Allowance for Credit Losses on Loans (“ACLL”) represents the Company’s estimate of amounts that are not expected to be collected over the contractual life of the Company’s held for investment loan portfolio. The estimate of the ACLL is based on historical experience, current conditions, and reasonable and supportable forecasts. As of December 31, 2022, the Company’s ACLL was \$47,512,000, and the provision for credit losses on loans was \$766,000 for the year then ended.

To estimate the ACLL, the Company uses a discounted cash flow methodology that includes loan level cash flow estimates for each loan segment based on peer and bank historic loss correlations with certain economic factors. The Company uses economic forecast data for the state of California including gross state product, unemployment rate, home price index and a national commercial real estate value index in their forecasting models. Management uses a four quarter forecast of each economic factor for each loan segment. The economic factors are assumed to revert to the historic mean over an eight quarter period after the four quarter forecast period. A significant amount of judgment is required to determine the reasonable and supportable forecasts. The Company also uses a qualitative analysis framework to address changes in risk due to loan quality trends, collateral risk, or other risks management determines are not adequately captured in the discounted cash flow loss estimation. Significant management judgment was applied in evaluating the qualitative adjustments used in the estimate.

The audit procedures over the reasonable and supportable forecasts involved a high degree of auditor judgment and required significant audit effort. Additionally, the audit procedures over the qualitative adjustments utilized in management’s methodology involved especially challenging and subjective auditor judgment. Therefore, we identified auditing the reasonable and supportable forecasts and the qualitative adjustments applied as a critical audit matter.

The primary audit procedures we performed to address this critical audit matter included the following:

- Tested the design and operating effectiveness of the Company’s controls over:
 - Management’s review of the appropriateness of the reasonable and supportable forecasts applied in the estimate of the ACLL, including the review of relevance and reliability of data used in the estimate.

- Management's review of the completeness and accuracy of internal data and relevance and reliability of external data used in the qualitative adjustments.
 - Management's review of the reasonableness of assumptions and judgments made for qualitative adjustments.
 - Management's review of the mathematical accuracy of the qualitative adjustments.
-

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- Evaluated management's judgments in the selection and application of reasonable and supportable forecasts, including the relevancy and reliability of data used in the estimate.
- Performed substantive testing over the qualitative adjustments including:
 - Tested the completeness and accuracy of internal data and relevance and reliability of external data used in the qualitative adjustments.
 - Assessed the appropriateness and reasonableness of the framework developed for the qualitative adjustments including evaluating management's judgments as to which factors impacted the qualitative adjustments for each portfolio segment.
 - Performed testing over the accuracy of inputs utilized in the calculation of qualitative adjustments for each portfolio segment.
 - Tested the mathematical accuracy of the calculation of qualitative factor adjustments.

/s/ CROWE LLP

Crowe LLP

We have served as the Company's auditor since 2005.

Oak Brook, Illinois
March 8, 2023

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HERITAGE COMMERCE CORP
CONSOLIDATED BALANCE SHEETS

	December 31, 2022	December 31, 2021
	(Dollars in thousands)	
Assets		
Cash and due from banks	\$ 27,595	\$ 15,703
Other investments and interest-bearing deposits in other financial institutions	279,008	1,290,513
Total cash and cash equivalents	306,603	1,306,216
Securities available-for-sale, at fair value	489,596	102,252
Securities held-to-maturity, at amortized cost, net of allowance for credit losses of \$14 at 2022 and \$43 at 2021 (fair value of \$614,452 at 2022 and \$657,649 at 2021)	714,990	658,397
Loans held-for-sale - SBA, at lower of cost or fair value, including deferred costs	2,456	2,367
Loans, net of deferred fees	3,298,550	3,087,326
Allowance for credit losses on loans	(47,512)	(43,290)
Loans, net	3,251,038	3,044,036
Federal Home Loan Bank, Federal Reserve Bank stock and other investments, at cost	32,522	32,504
Company-owned life insurance	78,945	77,589
Premises and equipment, net	9,301	9,639
Goodwill	167,631	167,631
Other intangible assets	11,033	13,668
Accrued interest receivable and other assets	93,465	85,110
Total assets	<u>\$ 5,157,580</u>	<u>\$ 5,499,409</u>
Liabilities and Shareholders' Equity		
Liabilities:		
Deposits:		
Demand, noninterest-bearing	\$ 1,736,722	\$ 1,903,768
Demand, interest-bearing	1,196,427	1,308,114
Savings and money market	1,285,444	1,375,825
Time deposits - under \$250	32,445	38,734
Time deposits - \$250 and over	108,192	94,700
CDARS - interest-bearing demand, money market and time deposits	30,374	38,271
Total deposits	4,389,604	4,759,412
Subordinated debt, net of issuance costs	39,350	39,925
Accrued interest payable and other liabilities	96,170	102,044
Total liabilities	<u>4,525,124</u>	<u>4,901,381</u>
Shareholders' equity:		
Preferred stock, no par value; 10,000,000 shares authorized; none issued and outstanding at 2022 and 2021	—	—
Common stock, no par value; 100,000,000 shares authorized; 60,852,723 shares issued and outstanding at 2022 and 60,339,837 shares issued and outstanding at 2021	502,923	497,695
Retained earnings	146,389	111,329
Accumulated other comprehensive loss	(16,856)	(10,996)
Total shareholders' equity	632,456	598,028
Total liabilities and shareholders' equity	<u>\$ 5,157,580</u>	<u>\$ 5,499,409</u>

See notes to consolidated financial statements

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HERITAGE COMMERCE CORP
CONSOLIDATED STATEMENTS OF INCOME

	Year Ended December 31,		
	2022	2021	2020
	(Dollars in thousands, except per share data)		
Interest income:			
Loans, including fees	\$ 153,010	\$ 139,244	\$ 133,169
Securities, taxable	20,666	8,678	11,637
Securities, exempt from Federal tax	1,084	1,576	1,908
Other investments, interest-bearing deposits			
in other financial institutions and Federal funds sold	14,068	3,758	3,757
Total interest income	<u>188,828</u>	<u>153,256</u>	<u>150,471</u>
Interest expense:			
Deposits	6,770	4,816	6,260
Subordinated debt	2,178	2,314	2,320
Short-term borrowings	<u>—</u>	<u>1</u>	<u>1</u>
Total interest expense	<u>8,948</u>	<u>7,131</u>	<u>8,581</u>
Net interest income before provision for credit losses on loans	179,880	146,125	141,890
Provision for (recapture of) credit losses on loans	<u>766</u>	<u>(3,134)</u>	<u>13,233</u>
Net interest income after provision for credit losses on loans	<u>179,114</u>	<u>149,259</u>	<u>128,657</u>
Noninterest income:			
Service charges and fees on deposit accounts	4,640	2,488	2,859
Increase in cash surrender value of life insurance	1,925	1,838	1,845
Gain on warrants	669	11	449
Servicing income	508	553	673
Gain on sales of SBA loans	491	1,718	839
Termination fees	61	797	89
Gain on proceeds from company-owned life insurance	27	675	20
Gain on the disposition of foreclosed assets	<u>—</u>	<u>—</u>	<u>791</u>
Gain on sales of securities	<u>—</u>	<u>—</u>	<u>277</u>
Other	<u>1,790</u>	<u>1,608</u>	<u>2,080</u>
Total noninterest income	<u>10,111</u>	<u>9,688</u>	<u>9,922</u>
Noninterest expense:			
Salaries and employee benefits	55,331	51,862	50,927
Occupancy and equipment	9,639	9,038	8,018
Professional fees	5,015	5,901	5,338
Other	<u>24,874</u>	<u>26,276</u>	<u>25,228</u>
Total noninterest expense	<u>94,859</u>	<u>93,077</u>	<u>89,511</u>
Income before income taxes	94,366	65,870	49,068
Income tax expense	<u>27,811</u>	<u>18,170</u>	<u>13,769</u>
Net income	<u>\$ 66,555</u>	<u>\$ 47,700</u>	<u>\$ 35,299</u>
Earnings per common share:			
Basic	\$ 1.10	\$ 0.79	\$ 0.59
Diluted	1.09	0.79	0.59

See notes to consolidated financial statements

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HERITAGE COMMERCE CORP
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

	December 31,		
	2022	2021	2020
	(Dollars in thousands)		
Net income	\$ 66,555	\$ 47,700	\$ 35,299
Other comprehensive income (loss):			
Change in net unrealized holding (losses) gains on available-for-sale securities and I/O strips	(19,079)	(2,953)	3,553
Deferred income taxes	5,532	1,177	(1,031)
Change in net unamortized unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity	—	(371)	(52)
Deferred income taxes	—	110	15
Reclassification adjustment for gains realized in income	—	—	(277)
Deferred income taxes	—	—	82
Change in unrealized (losses) gains on securities and I/O strips, net of deferred income taxes	(13,547)	(2,037)	2,290
Change in net pension and other benefit plan liability adjustment	9,909	2,219	(4,036)
Deferred income taxes	(2,222)	(461)	807
Change in pension and other benefit plan liability, net of deferred income taxes	7,687	1,758	(3,229)
Other comprehensive (loss)	(5,860)	(279)	(939)
Total comprehensive income	\$ 60,695	\$ 47,421	\$ 34,360

See notes to consolidated financial statements

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HERITAGE COMMERCE CORP
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

	Years Ended December 31, 2022, 2021 and 2020				
	Common Stock		Retained Earnings	Accumulated Other Comprehensive Loss	Total Shareholders' Equity
	Shares	Amount (Dollars in thousands, except per share data)			
Balance, January 1, 2020	59,368,156	\$489,745	\$ 96,741	\$ (9,778)	\$ 576,708
Net income	—	—	35,299	—	35,299
Cumulative effect of change in accounting principles (Note 1)	—	—	(6,062)	—	(6,062)
Other comprehensive income	—	—	—	(939)	(939)
Issuance of restricted stock awards, net	168,117	—	—	—	—
Amortization of restricted stock awards, net of forfeitures	—	1,689	—	—	1,689
Cash dividend declared \$0.52 per share	—	—	(31,079)	—	(31,079)
Stock option expense, net of forfeitures	—	559	—	—	559
Stock options exercised	381,184	1,714	—	—	1,714
Balance, December 31, 2020	59,917,457	493,707	94,899	(10,717)	577,889
Net income	—	—	47,700	—	47,700
Other comprehensive loss	—	—	—	(279)	(279)
Issuance of restricted stock awards, net	152,967	—	—	—	—
Amortization of restricted stock awards, net of forfeitures and taxes	—	1,940	—	—	1,940
Cash dividend declared \$0.52 per share	—	—	(31,270)	—	(31,270)
Stock option expense, net of forfeitures and taxes	—	579	—	—	579
Stock options exercised	269,413	1,469	—	—	1,469
Balance, December 31, 2021	60,339,837	497,695	111,329	(10,996)	598,028
Net income	—	—	66,555	—	66,555
Other comprehensive loss	—	—	—	(5,860)	(5,860)
Issuance of restricted stock awards, net	207,006	—	—	—	—
Amortization of restricted stock awards, net of forfeitures and taxes	—	2,583	—	—	2,583
Cash dividend declared \$0.52 per share	—	—	(31,495)	—	(31,495)
Stock option expense, net of forfeitures and taxes	—	595	—	—	595
Stock options exercised	305,880	2,050	—	—	2,050
Balance, December 31, 2022	60,852,723	\$502,923	\$146,389	\$ (16,856)	\$ 632,456

See notes to consolidated financial statements

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HERITAGE COMMERCE CORP
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended December 31,		
	2022	2021	2020
	(Dollars in thousands)		
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	\$ 66,555	\$ 47,700	\$ 35,299
Adjustments to reconcile net income to net cash provided by operating activities:			
Amortization of discounts and premiums on securities	(953)	3,649	3,747
Gain on sale of securities available-for-sale	—	—	(277)
Gain on sale of SBA loans	(491)	(1,718)	(839)
Proceeds from sale of SBA loans originated for sale	7,689	18,324	11,154
SBA loans originated for sale	(7,767)	(17,274)	(10,962)
Loss on the disposition of foreclosed assets	—	—	(791)
Provision for (recapture of) credit losses on loans	766	(3,134)	13,233
Increase in cash surrender value of life insurance	(1,925)	(1,838)	(1,845)
Depreciation and amortization	1,121	1,072	951
Amortization of other intangible assets	2,635	2,996	3,751
Stock option expense, net	595	579	559
Amortization of restricted stock awards, net	2,583	1,940	1,689
Amortization of subordinated debt issuance costs	172	185	186
Gain on proceeds from company-owned life insurance	(27)	(675)	(20)
Effect of changes in:			
Accrued interest receivable and other assets	978	6,127	8,101
Accrued interest payable and other liabilities	(2,078)	(1,084)	(6,641)
Net cash provided by operating activities	<u>69,853</u>	<u>56,849</u>	<u>57,295</u>
CASH FLOWS FROM INVESTING ACTIVITIES:			
Purchase of securities available-for-sale	(425,721)	—	—
Purchase of securities held-to-maturity	(146,548)	(474,017)	(30,916)
Maturities/paydowns/calls of securities available-for-sale	21,881	129,191	114,662
Maturities/paydowns/calls of securities held-to-maturity	88,394	110,823	97,365
Proceeds from sales of securities available-for-sale	—	—	56,598
Proceeds from the disposition of foreclosed assets	—	—	791
Purchase of mortgage loans	(185,426)	(405,752)	—
Net change in loans	(21,862)	(60,289)	(85,646)
Changes in Federal Home Loan Bank stock and other investments	(18)	1,018	(3,680)
Purchase of premises and equipment	(783)	(252)	(3,160)
Proceeds from redemption of company-owned life insurance	596	2,447	369
Net cash (used in) provided by investing activities	<u>(669,487)</u>	<u>(696,831)</u>	<u>146,383</u>
CASH FLOWS FROM FINANCING ACTIVITIES:			
Net change in deposits	(369,808)	844,926	499,718
Net change in short-term borrowings	—	—	(328)
Exercise of stock options	2,050	1,469	1,714
Payment of cash dividends	(31,495)	(31,270)	(31,079)
Redemption of subordinated debt	(40,000)	—	—
Issuance of subordinated debt, net of issuance costs	39,274	—	—
Net cash (used-in) provided by financing activities	<u>(399,979)</u>	<u>815,125</u>	<u>470,025</u>
Net (decrease) increase in cash and cash equivalents	(999,613)	175,143	673,703
Cash and cash equivalents, beginning of period	1,306,216	1,131,073	457,370
Cash and cash equivalents, end of period	<u>\$ 306,603</u>	<u>\$ 1,306,216</u>	<u>\$ 1,131,073</u>
Supplemental disclosures of cash flow information:			
Interest paid	\$ 8,654	\$ 7,014	\$ 8,558
Income taxes paid, net	25,175	15,372	10,640
Supplemental schedule of non-cash activity:			
Recording of right to use assets in exchange for lease obligations	2,736	2,977	26,654
Transfer of loans held-for-sale to loan portfolio	480	—	—

See notes to consolidated financial statements

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1) Summary of Significant Accounting Policies

Description of Business and Basis of Presentation

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

CSNK Working Capital Finance Corp. a California corporation, dba Bay View Funding (“Bay View Funding”) is a wholly owned subsidiary of HBC. Bay View Funding’s primary business operation is purchasing and collecting factored receivables. Factored receivables are receivables that have been transferred by the originating organization and typically have not been subject to previous collection efforts. In a factoring transaction Bay View Funding directly purchases the receivables generated by its clients at a discount to their face value. The transactions are structured to provide the clients with immediate working capital when there is a mismatch between payments to the client for a good and service and the payment of operating costs incurred to provide such good or service.

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

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash and Cash Equivalents

Cash and cash equivalents include cash on hand, amounts due from banks, amounts held at the Federal Reserve Bank, and Federal funds sold. In response to the COVID pandemic, the Federal Reserve lowered the reserve requirement ratios to 0% effective March 26, 2020, and therefore, the Bank had no required reserve balance at December 31, 2022 and 2021. Federal funds are generally sold and purchased for one-day periods.

Cash Flows

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

Securities

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

Interest income includes amortization of purchase premiums or discounts. Premiums and discounts are amortized, or accreted, over the life of the related security, or the earliest call date for callable securities purchased at a premium, as

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an adjustment to income using a method that approximates the interest method. Realized gains and losses are recorded on the trade date and determined using the specific identification method for the cost of securities sold.

Allowance for Credit Losses – Available-for-sale Securities

For available-for-sale debt securities in an unrealized loss position, the Company assesses whether it intends to sell, or if it is more likely than not that it will be required to sell the security before recovery of its amortized cost basis. If either of the criteria regarding the intent or requirement to sell is met, the security's amortized cost basis is written down to fair value through income. For debt securities available-for-sale that do not meet the aforementioned criteria, the Company evaluates whether the decline in fair value has resulted from credit losses or other factors. In making this assessment, management considers the extent to which fair value is less than amortized cost, any changes to the rating of the security by rating agency, and adverse conditions specifically related to the security. If the present value of cash flows expected to be collected is less than the amortized cost basis, a credit loss exists and an allowance for credit losses is recorded for the credit loss, limited by the amount that the fair value is less than the amortized cost basis. Any impairment that has not been recorded through an allowance for credit losses is recognized in other comprehensive income.

Changes in the allowance for credit losses are recorded as a provision (or reversal of) credit loss expense. Losses are charged against the allowance when management believes the uncollectibility of an available-for-sale security is confirmed or when either of the criteria regarding intent or requirement to sell is met.

Allowance for Credit Losses – Held-to-Maturity Securities

Management measures expected credit losses on held-to-maturity debt securities on a collective basis by major security type and bond rating. The estimate of expected credit losses considers historical loss information that is adjusted for current conditions and reasonable and supportable forecasts.

Management classifies the held-to-maturity portfolio in the following major security types: Agency mortgage-backed and municipal securities.

All the mortgage-backed securities held by the Company are issued by U.S. government entities and agencies. These securities are either explicitly or implicitly guaranteed by the U.S. government, are highly rated by major rating agencies, and have a long history of no credit losses.

Other securities are comprised primarily of tax exempt municipal securities. At December 31, 2022, all of these securities are rated A-Aaa (defined as investment grade). The issuers in these securities are primarily municipal entities and school districts.

Loan Sales and Servicing

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

Gains or losses on SBA loans held-for-sale are recognized upon completion of the sale, based on the difference between the selling price and the carrying value of the related loan sold.

SBA loans are sold with servicing retained. Servicing assets recognized separately upon the sale of SBA loans consist of servicing rights and, for loans sold prior to 2009, interest-only strip receivables ("I/O strips"). The Company accounts for the sale and servicing of SBA loans based on the financial and servicing assets it controls and liabilities it has incurred, reversing recognition of financial assets when control has been surrendered, and reversing recognition of liabilities when extinguished. Servicing rights are initially recorded at fair value with the income statement effect recorded in gains on sale of loans. Servicing rights are amortized in proportion to and over the period of net servicing income and are assessed for impairment on an ongoing

basis. Impairment is determined by stratifying the servicing rights based on interest rates and terms. Any servicing assets in excess of the contractually specified servicing fees are reclassified at fair value as an I/O strip receivable and treated like an available for sale security. Fair value is determined using prices for

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similar assets with similar characteristics, when available, or based upon discounted cash flows using market-based assumptions. Impairment is recognized through a valuation allowance. The servicing rights, net of any required valuation allowance, and I/O strip receivable are included in other assets on the consolidated balance sheets.

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

Loans

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are stated at the principal amount outstanding, net of deferred loan origination fees and costs on originated loans, or unamortized premiums or discounts on purchased or acquired loans, and an allowance for credit losses on loans. Accrued interest receivable is excluded from the estimate of credit losses. Interest on loans is accrued on the unpaid principal balance and is credited to income using the effective yield interest method. Interest on purchased or acquired loans and the accretion (amortization) of the related purchase discount (premium) is also credited to income using the effective yield interest method.

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

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

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

Allowance for Credit Losses on Loans

On January 1, 2020, the Company adopted the current expected credit loss (“CECL”) model under Accounting Standards Update (“ASU”) 2016-13 (Topic 326) using the modified retrospective approach. The allowance for credit losses on loans is an estimate of the current expected credit losses in the loan portfolio. Loans are charged-off against the allowance when management determines that a loan balance has become uncollectible. Subsequent recoveries, if any, are credited to the allowance for credit losses on loans.

Management’s methodology for estimating the allowance balance consists of several key elements, which include pooling loans with similar characteristics into segments and using a discounted cash flow calculation to estimate losses. The discounted cash flow model inputs include loan level cash flow estimates for each loan segment based on peer and bank historic loss correlations with certain economic factors. Management uses a four quarter forecast of each economic factor that is used for each loan segment and the economic factors are assumed to revert to the historic mean over an eight quarter period after the forecast period. The economic factors management has selected include the California unemployment rate, California gross domestic product, California home price index, and a national CRE value index. These factors are evaluated and updated occasionally and as economic conditions change. Additionally, management uses qualitative adjustments to the discounted cash flow quantitative loss estimates in certain cases when management has assessed an adjustment is necessary. These qualitative adjustments are applied by pooled loan segment and have been made for increased risk due to loan quality trends, collateral risk, or other risks

management determines are not adequately captured in the discounted cash flow loss estimation. Specific allowances on individually evaluated loans are combined to the allowance on pools of loans with similar risk characteristics to derive to total allowance for credit losses on loans.

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Management has also considered other qualitative risks such as collateral values, concentrations of credit risk (geographic, large borrower, and industry), economic conditions, changes in underwriting standards, experience and depth of lending staff, trends in delinquencies, and the level of criticized loans to address asset-specific risks and current conditions that were not fully considered by the macroeconomic variables driving the quantitative estimate.

The allowance for credit losses on loans was calculated by pooling loans of similar credit risk characteristics and credit monitoring procedures. The loan portfolio is classified into eight segments of loans - commercial, commercial real estate – owner occupied, commercial real estate – non-owner occupied, land and construction, home equity, multifamily, residential mortgages and consumer and other loans.

The risk characteristics of each loan portfolio segment are as follows:

Commercial

Commercial loans primarily rely on the identified cash flows of the borrower for repayment and secondarily on the underlying collateral provided by the borrower. However, the cash flows of the borrowers may not be as expected and the collateral securing these loans may vary in value. Most commercial loans are secured by the assets being financed or other business assets such as accounts receivable, inventory or equipment and may incorporate a personal guarantee; however, some loans may be unsecured. Included in commercial loans are \$1,166,000 of SBA Paycheck Protection Program (“PPP”) loans and \$79,263,000 of Bay View Funding factored receivables at December 31, 2022, compared to \$88,726,000 and \$53,229,000, respectively at December 31, 2021. No allowance for credit losses has been recorded for PPP loans as they are fully guaranteed by the SBA.

Commercial Real Estate (“CRE”)

CRE loans rely primarily on the cash flows of the properties securing the loan and secondarily on the value of the property that is securing the loan. CRE loans comprise two segments differentiated by owner occupied CRE and non-owner CRE. Owner occupied CRE loans are secured by commercial properties that are at least 50% occupied by the borrower or borrower affiliate. Non-owner occupied CRE loans are secured by commercial properties that are less than 50% occupied by the borrower or borrower affiliate. CRE loans may be adversely affected by conditions in the real estate markets or in the general economy.

Land and Construction

Land and construction loans are generally based on estimates of costs and value associated with the complete project. Construction loans usually involve the disbursement of funds with repayment substantially dependent on the success of the completion of the project. Sources of repayment for these loans may be permanent loans from HBC or other lenders, or proceeds from the sales of the completed project. These loans are monitored by on-site inspections and are considered to have higher risk than other real estate loans due to the final repayment dependent on numerous factors including general economic conditions.

Home Equity

Home equity loans are secured by 1-4 family residences that are generally owner occupied. Repayment of these loans depends primarily on the personal income of the borrower and secondarily by the value of the property securing the loan which can be impacted by changes in economic conditions such as the unemployment rate and property values. These loans are generally revolving lines of credit.

Multifamily

Multifamily loans are loans on residential properties with five or more units. These loans rely primarily on the cash flows of the properties securing the loan for repayment and secondarily on the value of the properties securing the loan. The cash flows of these borrowers can fluctuate along with the values of the underlying property depending on general economic conditions.

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Residential Mortgages

Residential mortgage loans are secured by 1-4 family residences which are generally owner-occupied. Repayment of these loans depends primarily on the personal income of the borrower and secondarily on the value of the property securing the loan which can be impacted by changes in economic conditions such as the unemployment rate and property values. These are generally term loans and are acquired.

Consumer and Other

Consumer and other loans are secured by personal property or are unsecured and rely primarily on the income of the borrower for repayment and secondarily on the collateral value for secured loans. Borrower income and collateral value can vary dependent on economic conditions.

Loan Commitments and Related Financial Instruments

Financial instruments include off-balance sheet credit instruments, such as commitments to make loans and commercial letters of credit, issued to meet customer financing needs. The face amount for these items represents the exposure to loss, before considering customer collateral or ability to repay. Such financial instruments are recorded when they are funded. The notional amount of these commitments is not reflected in the consolidated financial statement until they are funded. The Company maintains an allowance for credit losses on unfunded commercial lending commitments and letters of credit to provide for the risk of loss inherent in these arrangements. The allowance is computed using a methodology similar to that used to determine the allowance for credit losses for loans, modified to take into account the probability of a drawdown on the commitment. The allowance for credit losses on unfunded loan commitments is classified as a liability account on the balance sheet and is adjusted as a provision for credit loss expense included in other noninterest expense.

Federal Home Loan Bank and Federal Reserve Bank Stock

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

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

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

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

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

Premises and Equipment

Land is carried at cost. Premises and equipment are stated at cost less accumulated depreciation. Depreciation and amortization are computed on the straight-line basis over the lesser of the respective lease terms or estimated useful lives. The Company owns one building which is being depreciated over 40 years.

Furniture, equipment, and leasehold improvements are depreciated over estimated useful lives generally ranging from five to fifteen years. The Company evaluates the recoverability of long-lived assets on an ongoing basis.

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Operating Lease Right of Use Assets and Liabilities

The Company determines if a lease is present at the inception of an agreement. Operating leases are capitalized at commencement and are discounted using the Company's FHLB borrowing rate for a similar term borrowing unless the lease defines an implicit rate within the contract.

The operating lease right of use assets represent the Company's right to use an underlying asset for the lease term, and the operating lease liabilities represent the obligation to make lease payments arising from the lease. Operating lease right of use assets and operating lease liabilities are recognized on the lease commencement date based on the present value of lease payments over the lease term. No significant judgments or assumptions were involved in developing the estimated operating lease liabilities as the Company's operating lease liabilities largely represent future rental expenses associated with operating leases and the borrowing rates are based on publicly available interest rates.

Business Combinations

The Company accounts for acquisitions of businesses using the acquisition method of accounting. Under the acquisition method, assets acquired and liabilities assumed are recorded at their estimated fair values at the date of acquisition. Management utilizes various valuation techniques including discounted cash flow analyses to determine these fair values. Any excess of the purchase price over amounts allocated to the acquired assets, including identifiable intangible assets, and liabilities assumed is recorded as goodwill.

Goodwill and Other Intangible Assets

Goodwill resulting from business combinations represents the excess of the purchase price over the fair value of the net assets of businesses acquired. Goodwill is assessed at least annually for impairment and any such impairment is recognized in the period identified. The Company's annual goodwill impairment testing date is November 30.

Other intangible assets consist of a core deposit intangible, a below market lease, an above market lease liability, a customer relationship and brokered relationship intangible assets. They are initially measured at fair value and then are amortized over their estimated useful lives. The core deposits intangible assets from the acquisitions are being amortized on an accelerated method over ten years. The below market value lease intangible assets are being amortized on the straight line method over three years. The above market lease adjustment is being amortized on the straight line method over 60 months. The customer relationship and brokered relationship intangible assets are being amortized over ten years.

Foreclosed Assets

Assets acquired through or instead of loan foreclosure are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. If fair value declines subsequent to foreclosure, a valuation allowance is recorded through operations. Operating costs after acquisition are expensed. Gains and losses on disposition are included in noninterest expense. There were no foreclosed assets at December 31, 2022 and 2021.

Retirement Plans

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

Loss Contingencies

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

probable fees that can be reasonably estimated. The Company's accounting policy for uncertain recoveries is to recognize the anticipated recovery when realization is deemed probable.

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Income Taxes

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

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

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

Stock-Based Compensation

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

Comprehensive Income (Loss)

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

Segment Reporting

HBC is a commercial bank serving customers located in Alameda, Contra Costa, Marin, San Benito, San Francisco, San Mateo, and Santa Clara counties of California. Bay View Funding provides business essential working capital factoring financing to various industries throughout the United States. No customer accounts for more than 10 percent of revenue for HBC or the Company. With the previous acquisition of Bay View Funding, the Company has two reportable segments consisting of Banking and Factoring.

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Reclassifications

Certain items in the consolidated financial statements for the years ended December 31, 2021 and 2020 were reclassified to conform to the 2022 presentation. These reclassifications did not affect previously reported net income or shareholders' equity.

Accounting Guidance Issued But Not Yet Adopted

In March 2020, the FASB issued ASU 2020-04, Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting. The ASU provides optional expedients and exceptions for applying GAAP to loan and lease agreements, derivative contracts, and other transactions affected by the anticipated transition away from London Inter-Bank Offered Rate ("LIBOR") toward new interest rate benchmarks. For transactions that are modified because of reference rate reform and that meet certain scope guidance (i) modifications of loan agreements should be accounted for by prospectively adjusting the effective interest rate and the modification will be considered "minor" so that any existing unamortized origination fees/costs would carry forward and continue to be amortized and (ii) modifications of lease agreements should be accounted for as a continuation of the existing agreement with no reassessments of the lease classification and the discount rate or remeasurements of lease payments that otherwise would be required for modifications *not* accounted for as separate contracts. ASU 2020-04 also provides numerous optional expedients for derivative accounting. In December 2022, to ensure relief in Topic 848 covers the period of time during which a significant number of modifications may take place, the FASB issued ASU No. 2022-06, which defers the sunset date of Topic 848 from December 31, 2022 to December 31, 2024, after which entities will no longer be permitted to apply relief in Topic 848. Once elected for a Topic or an Industry Subtopic within the Codification, the amendments in this ASU must be applied prospectively for all eligible contract modifications for that Topic or Industry Subtopic. The Company does not expect any material impact on its consolidated financial statements since the Company has an insignificant number of financial instruments applicable to this ASU.

In March 2022, the FASB issued ASU No. 2022-02 Financial Instruments – Credit Losses (Topic 326): Troubled Debt Restructurings and Vintage Disclosures, which 1) eliminates the accounting guidance for troubled debt restructurings ("TDRs") by creditors while enhancing the disclosure requirements for certain loan refinancings and restructurings by creditors when a borrower is experiencing financial difficulty; and 2) requires that an entity disclose current-period gross writeoffs by year of origination for financing receivables and net investments in leases. ASU 2022-02 is effective for fiscal years beginning after December 15, 2022 and the amendments should be applied prospectively, although the entity has the option to apply a modified retrospective transition method for the recognition and measurement of TDRs, resulting in a cumulative-effect adjustment to retained earnings in the period of adoption. The Company is currently evaluating the impact of adopting the new guidance on its consolidated financial statements, however, the impact is not expected to be material.

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2) Accumulated Other Comprehensive Income (“AOCI”)

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

	Year Ended December 31, 2022 and 2021				
	Unamortized Unrealized Gains (Losses) on Available-for-Sale Securities and I/O Strips	Gain on Available-for-Sale Securities Reclassified to Held-to-Maturity	Defined Benefit Pension Plan Items(1)	Total	
	(Dollars in thousands)				
Beginning balance January 1, 2022, net of taxes	\$ 2,153	\$ —	\$ (13,149)	\$ (10,996)	
Other comprehensive (loss) before reclassification, net of taxes	(13,547)	—	7,395	(6,152)	
Amounts reclassified from other comprehensive income, net of taxes	—	—	292	292	
Net current period other comprehensive income (loss), net of taxes	(13,547)	—	7,687	(5,860)	
Ending balance December 31, 2022, net of taxes	\$ (11,394)	\$ —	\$ (5,462)	\$ (16,856)	
Beginning balance January 1, 2021, net of taxes	\$ 3,929	\$ 261	\$ (14,907)	\$ (10,717)	
Other comprehensive (loss) before reclassification, net of taxes	(1,776)	—	1,308	(468)	
Amounts reclassified from other comprehensive income (loss), net of taxes	—	(261)	450	189	
Net current period other comprehensive income (loss), net of taxes	(1,776)	(261)	1,758	(279)	
Ending balance December 31, 2021, net of taxes	\$ 2,153	\$ —	\$ (13,149)	\$ (10,996)	

-
- (1) This AOCI component is included in the computation of net periodic benefit cost (see Note 13—Benefit Plans) and includes split-dollar life insurance benefit plan.
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Details About AOCI Components	Amounts Reclassified from AOCI Year Ended December 31,			Affected Line Item Where Net Income is Presented
	2022	2021	2020	
	(Dollars in thousands)			
Unrealized gains on available-for-sale securities and I/O strips	\$ —	\$ —	\$ 277	Gain on sales of securities
	—	—	(82)	Income tax expense
	—	—	195	Net of tax
Amortization of unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity	\$ —	\$ 371	52	Interest income on taxable securities
	—	(110)	(15)	Income tax expense
	—	261	37	Net of tax
Amortization of defined benefit pension plan items ⁽¹⁾				
Prior transition obligation and actuarial losses ⁽²⁾	41	4	60	
Prior service cost and actuarial losses ⁽³⁾	(455)	(643)	(387)	
	(414)	(639)	(327)	Other noninterest expense
	122	189	97	Income tax expense
	(292)	(450)	(230)	Net of tax
Total reclassification from AOCI for the period	\$ (292)	\$ (189)	\$ 2	

- (1) This AOCI component is included in the computation of net periodic benefit cost (see Note 13 — *Benefit Plans*).
(2) This is related to the split dollar life insurance benefit plan.
(3) This is related to the supplemental executive retirement plan.

3) Securities

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

December 31, 2022	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Allowance for Credit Losses	Estimated Fair Value
	(Dollars in thousands)				
Securities available-for-sale:					
U.S. Treasury	\$ 428,797	\$ —	\$ (10,323)	\$ —	\$ 418,474
Agency mortgage-backed securities	76,916	—	(5,794)	—	71,122
Total	<u>\$505,713</u>	<u>\$ —</u>	<u>\$ (16,117)</u>	<u>\$ —</u>	<u>\$489,596</u>
December 31, 2022	Amortized Cost	Gross Unrecognized Gains	Gross Unrecognized (Losses)	Estimated Fair Value	Allowance for Credit Losses
	(Dollars in thousands)				
Securities held-to-maturity:					
Agency mortgage-backed securities	\$ 677,381	\$ 235	\$ (99,977)	\$ 577,639	\$ —
Municipals - exempt from Federal tax	37,623	9	(819)	36,813	(14)
Total	<u>\$715,004</u>	<u>\$ 244</u>	<u>\$ (100,796)</u>	<u>\$ 614,452</u>	<u>\$ (14)</u>

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<u>December 31, 2021</u>	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized (Losses)</u> (Dollars in thousands)	<u>Allowance for Credit Losses</u>	<u>Estimated Fair Value</u>
Securities available-for-sale:					
Agency mortgage-backed securities	\$ 99,359	\$ 2,893	\$ —	\$ —	\$102,252
Total	<u>\$ 99,359</u>	<u>\$ 2,893</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$102,252</u>
 December 31, 2021					
	<u>Amortized Cost</u>	<u>Gross Unrecognized Gains</u>	<u>Gross Unrecognized (Losses)</u> (Dollars in thousands)	<u>Estimated Fair Value</u>	<u>Allowance for Credit Losses</u>
Securities held-to-maturity:					
Agency mortgage-backed securities	\$607,377	\$ 3,157	\$ (4,752)	\$ 605,782	\$ —
Municipals - exempt from Federal tax	51,063	804	—	51,867	(43)
Total	<u>\$658,440</u>	<u>\$ 3,961</u>	<u>\$ (4,752)</u>	<u>\$ 657,649</u>	<u>\$ (43)</u>

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

<u>December 31, 2022</u>	<u>Less Than 12 Months</u>		<u>12 Months or More</u>		<u>Total</u>	
	<u>Fair Value</u>	<u>Unrealized (Losses)</u>	<u>Fair Value</u>	<u>Unrealized (Losses)</u>	<u>Fair Value</u>	<u>Unrealized (Losses)</u>
Securities available-for-sale:						
U.S. Treasury	\$418,474	\$(10,323)	\$ —	\$ —	\$418,474	\$ (10,323)
Agency mortgage-backed securities	71,122	(5,794)	—	—	71,122	(5,794)
Total	<u>\$489,596</u>	<u>\$(16,117)</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$489,596</u>	<u>\$(16,117)</u>
<u>December 31, 2022</u>	<u>Less Than 12 Months</u>		<u>12 Months or More</u>		<u>Total</u>	
	<u>Fair Value</u>	<u>Unrealized (Losses)</u>	<u>Fair Value</u>	<u>Unrealized (Losses)</u>	<u>Fair Value</u>	<u>Unrealized (Losses)</u>
Securities held-to-maturity:						
Agency mortgage-backed securities	\$136,264	\$(12,866)	\$429,257	\$(87,111)	\$565,521	\$ (99,977)
Municipals — exempt from Federal tax	31,007	(819)	—	—	31,007	(819)
Total	<u>\$167,271</u>	<u>\$(13,685)</u>	<u>\$429,257</u>	<u>\$(87,111)</u>	<u>\$596,528</u>	<u>\$(100,796)</u>
<u>December 31, 2021</u>	<u>Less Than 12 Months</u>		<u>12 Months or More</u>		<u>Total</u>	
	<u>Fair Value</u>	<u>Unrealized (Losses)</u>	<u>Fair Value</u>	<u>Unrealized (Losses)</u>	<u>Fair Value</u>	<u>Unrealized (Losses)</u>
Securities held-to-maturity:						
Agency mortgage-backed securities	\$408,856	\$ (3,319)	\$27,997	\$ (1,433)	\$436,853	\$ (4,752)
Total	<u>\$408,856</u>	<u>\$ (3,319)</u>	<u>\$27,997</u>	<u>\$ (1,433)</u>	<u>\$436,853</u>	<u>\$ (4,752)</u>

There were no holdings of securities of any one issuer, other than the U.S. Government and its sponsored entities, in an amount greater than 10% of shareholders' equity. At December 31, 2022, the Company held 463 securities (173 available-for-sale and 290 held-to-maturity), of which 439 had fair values below amortized cost. At December 31, 2022, there were \$418,474,000 of U.S. Treasury securities available-for-sale, \$71,122,000 of agency mortgage-backed securities available-for-sale, \$136,264,000 of agency mortgage-backed securities held-to-maturity, and \$31,007,000 of municipal securities held-to-maturity, carried with an unrealized loss for less than 12 months, and \$429,257,000 of agency mortgage-backed securities held-to-maturity, carried with an unrealized loss for 12 months or more. The total unrealized loss for securities less than 12 months was \$(29,802,000) and the total unrealized loss for securities carried for 12 months or more was \$(87,111,000) at December 31, 2022. The unrealized losses were due to higher interest rates at period end compared to when the securities were purchased. The issuers are of high credit quality and all principal

amounts are expected to be paid when securities mature. The fair value is expected to recover as the securities approach their maturity date and/or

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market rates decline. The Company does not believe that it is more likely than not that the Company will be required to sell a security in an unrealized loss position prior to recovery in value. The Company does not consider these securities to have credit-related losses at December 31, 2022.

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

	2022	2021 (Dollars in thousands)	2020
Proceeds	\$ —	\$ —	\$ 56,598
Gross gains	—	—	277
Gross losses	—	—	—

The amortized cost and fair value of debt securities as of December 31, 2022, by contractual maturity, are shown below. The expected maturities will differ from contractual maturities if borrowers have the right to call or prepay obligations with or without call or prepayment penalties. Securities not due at a single maturity date are shown separately.

	Available-for-sale	
	Amortized Cost	Estimated Fair Value
	(Dollars in thousands)	(Dollars in thousands)
Due after 3 months through one year	\$ 46,065	\$ 45,736
Due after one through five years	382,732	372,738
Agency mortgage-backed securities	76,916	71,122
Total	<u>\$505,713</u>	<u>\$489,596</u>

	Held-to-maturity	
	Amortized Cost	Estimated Fair Value
	(Dollars in thousands)	(Dollars in thousands)
Due after three months through one year	\$ 554	\$ 553
Due after one through five years	7,681	7,613
Due after five through ten years	27,459	26,745
Due after ten years	1,929	1,902
Agency mortgage-backed securities	677,381	577,639
Total	<u>\$715,004</u>	<u>\$614,452</u>

Securities with amortized cost of \$66,272,000 and \$42,473,000 as of December 31, 2022 and 2021 were pledged to secure public deposits and for other purposes as required or permitted by law or contract.

The table below presents a roll-forward by major security type for the year ended December 31, 2022 of the allowance for credit losses on debt securities held-to-maturity held at period end:

	Municipals
	(Dollars in thousands)
Beginning balance January 1, 2022	\$ 43
Provision for (recapture of) credit losses	(29)
Ending balance December 31, 2022	<u>\$ 14</u>

For the year ended December 31, 2022, there was a reduction of \$29,000 to the allowance for credit losses on the Company's held-to-maturity municipal investment securities portfolio. This reduction was the result of a reduction in municipal securities amortized balances resulting from regular payments.

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4) Loans and Allowance for Credit Losses on Loans

The allowance for credit losses on loans was calculated by pooling loans of similar credit risk characteristics and credit monitoring procedures. The loan portfolio is classified into eight segments of loans - commercial, commercial real estate – owner occupied, commercial real estate – non-owner occupied, land and construction, home equity, multifamily, residential mortgage and consumer and other. See *Note 1 – Summary of Significant Accounting Policies - Allowance for Credit Losses on Loans* for the summary of risk characteristics of each loan segment.

Loans by portfolio segment and the allowance for credit losses on loans were as follows for the periods indicated:

	December 31, 2022	December 31, 2021
	(Dollars in thousands)	
Loans held-for-investment:		
Commercial	\$ 533,915	\$ 682,834
Real estate:		
CRE - owner occupied	614,663	595,934
CRE - non-owner occupied	1,066,368	902,326
Land and construction	163,577	147,855
Home equity	120,724	109,579
Multifamily	244,882	218,856
Residential mortgages	537,905	416,660
Consumer and other	17,033	16,744
Loans	3,299,067	3,090,788
Deferred loan fees, net	(517)	(3,462)
Loans, net of deferred fees	3,298,550	3,087,326
Allowance for credit losses on loans	(47,512)	(43,290)
Loans, net	<u>\$ 3,251,038</u>	<u>\$ 3,044,036</u>

Changes in the allowance for credit losses on loans were as follows:

	Year Ended December 31, 2022								
	CRE Commercial	CRE Owner Occupied	CRE Non-owner Occupied	Land & Construction	Home Equity	Multi- Family	Residential Mortgage	Consumer and Other	Total
Beginning of period balance	\$ 8,414	\$ 7,954	\$ 17,125	\$ 1,831	\$ 864	\$ 2,796	\$ 4,132	\$ 174	\$ 43,290
Charge-offs	(434)	—	—	—	—	—	—	—	(434)
Recoveries	427	15	—	—	105	—	—	—	3,343
Net recoveries	(7)	15	—	—	105	—	—	—	3,343
Provision for (recapture of) credit losses on loans	(1,790)	(2,218)	5,010	1,110	(303)	570	1,775	(3,388)	766
End of period balance	<u>\$ 6,617</u>	<u>\$ 5,751</u>	<u>\$ 22,135</u>	<u>\$ 2,941</u>	<u>\$ 666</u>	<u>\$ 3,366</u>	<u>\$ 5,907</u>	<u>\$ 129</u>	<u>\$ 47,512</u>

	Year Ended December 31, 2021								
	CRE Commercial	CRE Owner Occupied	CRE Non-owner Occupied	Land & Construction	Home Equity	Multi- Family	Residential Mortgage	Consumer and Other	Total
Beginning of period balance	\$ 11,587	\$ 8,560	\$ 16,416	\$ 2,509	\$ 1,297	\$ 2,804	\$ 943	\$ 284	\$ 44,400
Charge-offs	(520)	—	—	—	—	—	—	—	(520)
Recoveries	1,354	16	—	884	93	—	—	197	2,544
Net (charge-offs) recoveries	834	16	—	884	93	—	—	197	2,024
Provision for (recapture of) credit losses on loans	(4,007)	(622)	709	(1,562)	(526)	(8)	3,189	(307)	(3,134)
End of period balance	<u>\$ 8,414</u>	<u>\$ 7,954</u>	<u>\$ 17,125</u>	<u>\$ 1,831</u>	<u>\$ 864</u>	<u>\$ 2,796</u>	<u>\$ 4,132</u>	<u>\$ 174</u>	<u>\$ 43,290</u>

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	Year Ended December 31, 2020								
	Commercial	Owner Occupied	Non-owner Occupied	Land & Construction	Home Equity	Multi-Family	Residential Mortgage	Consumer and Other	Total
(Dollars in thousands)									
Beginning of period balance	\$ 10,453	\$ 3,825	\$ 3,760	\$ 2,621	\$ 2,244	\$ 57	\$ 243	\$ 82	\$ 23,285
Adoption of Topic 326	(3,663)	3,169	7,912	(1,163)	(923)	1,196	435	1,607	8,570
Balance at adoption on January 1, 2020	6,790	6,994	11,672	1,458	1,321	1,253	678	1,689	31,855
Charge-offs	(1,776)	—	—	—	—	—	—	(104)	(1,880)
Recoveries	998	1	—	70	93	—	—	30	1,192
Net (charge-offs) recoveries	(778)	1	—	70	93	—	—	(74)	(688)
Provision for (recapture of) credit losses on loans	5,575	1,565	4,744	981	(117)	1,551	265	(1,331)	13,233
End of period balance	<u>\$ 11,587</u>	<u>\$ 8,560</u>	<u>\$ 16,416</u>	<u>\$ 2,509</u>	<u>\$ 1,297</u>	<u>\$ 2,804</u>	<u>\$ 943</u>	<u>\$ 284</u>	<u>\$ 44,400</u>

The following table presents the amortized cost basis of nonaccrual loans and loans past due over 90 days and still accruing at the periods indicated:

	December 31, 2022			
	Nonaccrual with no Specific Allowance for Credit Losses	Nonaccrual with Specific Allowance for Credit Losses	Restructured and Loans over 90 Days Past Due and Still Accruing	Total
	(Dollars in thousands)			
Commercial	\$ 318	\$ 324	\$ 349	\$ 991
Real estate:				
CRE - Non-Owner Occupied	—	—	1,336	1,336
Home equity	98	—	—	98
Total	<u>\$ 416</u>	<u>\$ 324</u>	<u>\$ 1,685</u>	<u>\$ 2,425</u>

	December 31, 2021			
	Nonaccrual with no Specific Allowance for Credit Losses	Nonaccrual with no Specific Allowance for Credit Losses	Restructured and Loans over 90 Days Past Due and Still Accruing	Total
	(Dollars in thousands)			
Commercial	\$ 94	\$ 1,028	\$ 278	\$ 1,400
Real estate:				
CRE - Owner Occupied	1,126	—	—	1,126
Home equity	84	—	—	84
Multifamily	1,128	—	—	1,128
Total	<u>\$ 2,432</u>	<u>\$ 1,028</u>	<u>\$ 278</u>	<u>\$ 3,738</u>

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

	December 31, 2022					
	30 - 59 Days Past Due	60 - 89 Days Past Due	90 Days or Greater Past Due	Total Past Due (Dollars in thousands)	Current	Total
Commercial	\$ 7,236	\$ 2,519	\$ 703	\$ 10,458	\$ 523,457	\$ 533,915
Real estate:						
CRE - Owner Occupied	252	—	—	252	614,411	614,663
CRE - Non-Owner Occupied	—	—	1,336	1,336	1,065,032	1,066,368
Land and construction	—	—	—	—	163,577	163,577
Home equity	—	98	—	98	120,626	120,724
Multifamily	—	—	—	—	244,882	244,882
Residential mortgages	4,202	720	—	4,922	532,983	537,905
Consumer and other		—	—	—	17,033	17,033
Total	<u>\$ 11,690</u>	<u>\$ 3,337</u>	<u>\$ 2,039</u>	<u>\$ 17,066</u>	<u>\$3,282,001</u>	<u>\$3,299,067</u>

	December 31, 2021					
	30 - 59 Days Past Due	60 - 89 Days Past Due	90 Days or Greater Past Due	Total Past Due (Dollars in thousands)	Current	Total
Commercial	\$ 2,714	\$ 168	\$ 408	\$ 3,290	\$ 679,544	\$ 682,834
Real estate:						
CRE - Owner Occupied	—	—	1,126	1,126	594,808	595,934
CRE - Non-Owner Occupied	—	—	—	—	902,326	902,326
Land and construction	—	—	—	—	147,855	147,855
Home equity	—	—	—	—	109,579	109,579
Multifamily	—	—	—	—	218,856	218,856
Residential mortgages	599	—	—	599	416,061	416,660
Consumer and other	—	—	—	—	16,744	16,744
Total	<u>\$ 3,313</u>	<u>\$ 168</u>	<u>\$ 1,534</u>	<u>\$ 5,015</u>	<u>\$3,085,773</u>	<u>\$3,090,788</u>

Past due loans 30 days or greater totaled \$17,066,000 and \$5,015,000 at December 31, 2022 and December 31, 2021, respectively, of which \$479,000 and \$1,258,000 were on nonaccrual. At December 31, 2022, there were also \$261,000 loans less than 30 days past due included in nonaccrual loans held-for-investment. At December 31, 2021, there were also \$2,202,000 loans less than 30 days past due included in nonaccrual loans held-for-investment. Management's classification of a loan as "nonaccrual" is an indication that there is reasonable doubt as to the full recovery of principal or interest on the loan. At that point, the Company stops accruing interest income, and reverses any uncollected interest that had been accrued as income. The Company begins recognizing interest income only as cash interest payments are received and it has been determined the collection of all outstanding principal is not in doubt.

Credit Quality Indicators

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

The Company categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit

documentation, public information, and current economic trends, and other factors. The Company analyzes loans individually by classifying the

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loans as to credit risk. This analysis is performed on a quarterly basis. Nonclassified loans generally include those loans that are expected to be repaid in accordance with their contractual loan terms. Loans categorized as special mention have potential weaknesses that may, if not checked or corrected, weaken the credit or inadequately protect the Company's position at some future date. These loans pose elevated risk, but their weaknesses do not yet justify a substandard classification. Classified loans are those loans that are assigned a substandard, substandard-nonaccrual, or doubtful risk rating using the following definitions:

Special Mention. A Special Mention asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in a deterioration of the repayment prospects for the asset or in the credit position at some future date. Special Mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.

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

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

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

Loss. Loans classified as loss are considered uncollectable or of so little value that their continuance as assets is not warranted. This classification does not necessarily mean that a loan has no recovery or salvage value; but rather, there is much doubt about whether, how much, or when the recovery would occur. Loans classified as loss are immediately charged off against the allowance for credit losses on loans. Therefore, there is no balance to report as of December 31, 2022 and December 31, 2021.

Loans may be reviewed at any time throughout a loan's duration. If new information is provided, a new risk assessment may be performed if warranted.

The following tables present term loans amortized cost by vintage and loan grade classification, and revolving loans amortized cost by loan grade classification at December 31, 2022 and December 31, 2021. The loan grade classifications are based on the Bank's internal loan grading methodology. Loan grade categories for doubtful and loss rated loans are not included on the tables below as there are no loans with those grades at December 31, 2022 and December 31, 2021. The vintage year represents the period the loan was originated or in the case of renewed loans, the period last renewed. The amortized balance is the loan balance less any purchase discounts, and plus any loan purchase premiums. The loan categories are based on the loan segmentation in the Company's CECL reserve methodology based on loan purpose and type.

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Term Loans Amortized Cost Basis by Originated Period as of December 31, 2022							Revolving Loans Amortized Cost Basis	Total
	2022	2021	2020	2019	2018	Prior Periods		
Commercial:								
Pass	\$ 102,969	\$ 36,752	\$ 24,406	\$ 19,272	\$ 12,089	\$ 21,127	\$ 293,546	\$ 510,161
Special Mention	3,408	1,060	192	1,123	-	6,031	5,551	17,365
Substandard	4	-	-	145	-	102	5,496	5,747
Substandard-Nonaccrual	-	279	-	-	330	33	-	642
Total	<u>106,381</u>	<u>38,091</u>	<u>24,598</u>	<u>20,540</u>	<u>12,419</u>	<u>27,293</u>	<u>304,593</u>	<u>533,915</u>
CRE - Owner Occupied:								
Pass	92,689	116,266	75,007	59,887	58,180	194,584	8,758	605,371
Special Mention	-	2,033	867	1,120	-	4,410	-	8,430
Substandard	-	660	-	-	193	9	-	862
Substandard-Nonaccrual	-	-	-	-	-	-	-	-
Total	<u>92,689</u>	<u>118,959</u>	<u>75,874</u>	<u>61,007</u>	<u>58,373</u>	<u>199,003</u>	<u>8,758</u>	<u>614,663</u>
CRE - Non-Owner Occupied:								
Pass	239,556	278,051	31,848	101,854	63,905	337,048	3,245	1,055,507
Special Mention	-	-	-	-	-	4,883	-	4,883
Substandard	-	-	-	-	-	5,978	-	5,978
Substandard-Nonaccrual	-	-	-	-	-	-	-	-
Total	<u>239,556</u>	<u>278,051</u>	<u>31,848</u>	<u>101,854</u>	<u>63,905</u>	<u>347,909</u>	<u>3,245</u>	<u>1,066,368</u>
Land and construction:								
Pass	62,241	72,847	22,459	6,030	-	-	-	163,577
Special Mention	-	-	-	-	-	-	-	-
Substandard	-	-	-	-	-	-	-	-
Substandard-Nonaccrual	-	-	-	-	-	-	-	-
Total	<u>62,241</u>	<u>72,847</u>	<u>22,459</u>	<u>6,030</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>163,577</u>
Home equity:								
Pass	-	-	-	-	-	44	117,950	117,994
Special Mention	-	-	-	-	-	-	2,346	2,346
Substandard	-	-	-	-	-	144	142	286
Substandard-Nonaccrual	-	98	-	-	-	-	-	98
Total	<u>-</u>	<u>98</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>188</u>	<u>120,438</u>	<u>120,724</u>
Multifamily:								
Pass	42,111	69,824	4,871	42,412	15,356	66,380	180	241,134
Special Mention	-	-	657	771	-	2,320	-	3,748
Substandard	-	-	-	-	-	-	-	-
Substandard-Nonaccrual	-	-	-	-	-	-	-	-
Total	<u>42,111</u>	<u>69,824</u>	<u>5,528</u>	<u>43,183</u>	<u>15,356</u>	<u>68,700</u>	<u>180</u>	<u>244,882</u>
Residential mortgage:								
Pass	191,907	296,270	1,068	6,788	2,724	33,290	-	532,047
Special Mention	-	-	-	1,058	1,482	2,387	-	4,927
Substandard	-	-	-	-	-	931	-	931
Substandard-Nonaccrual	-	-	-	-	-	-	-	-
Total	<u>191,907</u>	<u>296,270</u>	<u>1,068</u>	<u>7,846</u>	<u>4,206</u>	<u>36,608</u>	<u>-</u>	<u>537,905</u>
Consumer and other:								
Pass	389	13	-	-	1,364	1,283	13,647	16,696
Special Mention	-	82	-	6	-	-	249	337
Substandard	-	-	-	-	-	-	-	-
Substandard-Nonaccrual	-	-	-	-	-	-	-	-
Total	<u>389</u>	<u>95</u>	<u>-</u>	<u>6</u>	<u>1,364</u>	<u>1,283</u>	<u>13,896</u>	<u>17,033</u>
Total loans	\$ 735,274	\$ 874,235	\$ 161,375	\$ 240,466	\$ 155,623	\$ 680,984	\$ 451,110	\$ 3,299,067
Risk Grades:								
Pass	\$ 731,862	\$ 870,023	\$ 159,659	\$ 236,243	\$ 153,618	\$ 653,756	\$ 437,326	\$ 3,242,487
Special Mention	3,408	3,175	1,716	4,078	1,482	20,031	8,146	42,036
Substandard	4	660	-	145	193	7,164	5,638	13,804
Substandard-Nonaccrual	-	377	-	-	330	33	-	740
Grand Total	\$ 735,274	\$ 874,235	\$ 161,375	\$ 240,466	\$ 155,623	\$ 680,984	\$ 451,110	\$ 3,299,067

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Term Loans Amortized Cost Basis by Originated Period as of December 31, 2021							Revolving Loans Amortized Cost Basis	Total
	2021	2020	2019	2018	2017	Prior Periods		
(Dollars in thousands)								
Commercial:								
Pass	\$ 208,645	65,257	\$ 15,086	\$ 12,281	\$ 7,311	\$ 5,507	\$ 349,717	\$ 663,804
Special Mention	2,210	512	219	764	243	204	4,024	8,176
Substandard	3,709	930	-	13	302	2	4,776	9,732
Substandard-Nonaccrual	595	442	37	-	-	48	-	1,122
Total	<u>215,159</u>	<u>67,141</u>	<u>15,342</u>	<u>13,058</u>	<u>7,856</u>	<u>5,761</u>	<u>358,517</u>	<u>682,834</u>
CRE - Owner Occupied:								
Pass	170,504	135,103	65,596	57,017	31,657	107,203	14,486	581,566
Special Mention	568	2,254	672	-	-	355	-	3,849
Substandard	985	6,042	-	1,477	-	889	-	9,393
Substandard-Nonaccrual	-	1,100	-	-	-	26	-	1,126
Total	<u>172,057</u>	<u>144,499</u>	<u>66,268</u>	<u>58,494</u>	<u>31,657</u>	<u>108,473</u>	<u>14,486</u>	<u>595,934</u>
CRE - Non-Owner Occupied:								
Pass	374,470	141,404	115,170	45,959	68,125	134,454	2,068	881,650
Special Mention	-	5,388	-	-	1,133	3,816	-	10,337
Substandard	-	5,842	-	-	-	4,497	-	10,339
Substandard-Nonaccrual	-	-	-	-	-	-	-	-
Total	<u>374,470</u>	<u>152,634</u>	<u>115,170</u>	<u>45,959</u>	<u>69,258</u>	<u>142,767</u>	<u>2,068</u>	<u>902,326</u>
Land and construction:								
Pass	125,844	11,401	4,385	-	-	1,300	3,566	146,496
Special Mention	1,359	-	-	-	-	-	-	1,359
Substandard	-	-	-	-	-	-	-	-
Substandard-Nonaccrual	-	-	-	-	-	-	-	-
Total	<u>127,203</u>	<u>11,401</u>	<u>4,385</u>	<u>-</u>	<u>-</u>	<u>1,300</u>	<u>3,566</u>	<u>147,855</u>
Home equity:								
Pass	-	-	-	46	-	-	106,738	106,784
Special Mention	-	-	-	-	-	-	1,931	1,931
Substandard	-	-	-	-	-	54	726	780
Substandard-Nonaccrual	-	84	-	-	-	-	-	84
Total	<u>-</u>	<u>84</u>	<u>-</u>	<u>46</u>	<u>-</u>	<u>54</u>	<u>109,395</u>	<u>109,579</u>
Multifamily:								
Pass	102,535	27,955	30,820	16,151	16,261	13,895	-	207,617
Special Mention	5,804	-	4,307	-	-	-	-	10,111
Substandard	-	-	-	-	-	-	-	-
Substandard-Nonaccrual	1,128	-	-	-	-	-	-	1,128
Total	<u>109,467</u>	<u>27,955</u>	<u>35,127</u>	<u>16,151</u>	<u>16,261</u>	<u>13,895</u>	<u>-</u>	<u>218,856</u>
Residential mortgage:								
Pass	360,424	17,875	8,065	3,070	6,015	19,967	-	415,416
Special Mention	-	-	-	-	-	1,244	-	1,244
Substandard	-	-	-	-	-	-	-	-
Substandard-Nonaccrual	-	-	-	-	-	-	-	-
Total	<u>360,424</u>	<u>17,875</u>	<u>8,065</u>	<u>3,070</u>	<u>6,015</u>	<u>21,211</u>	<u>-</u>	<u>416,660</u>
Consumer and other:								
Pass	491	2	40	1,426	14	1,000	13,756	16,729
Special Mention	-	-	-	-	-	-	-	-
Substandard	15	-	-	-	-	-	-	15
Substandard-Nonaccrual	-	-	-	-	-	-	-	-
Total	<u>506</u>	<u>2</u>	<u>40</u>	<u>1,426</u>	<u>14</u>	<u>1,000</u>	<u>13,756</u>	<u>16,744</u>
Total loans	<u>\$ 1,359,286</u>	<u>421,591</u>	<u>\$ 244,397</u>	<u>\$ 138,204</u>	<u>\$ 131,061</u>	<u>\$ 294,461</u>	<u>\$ 501,788</u>	<u>\$ 3,090,788</u>
Risk Grades:								
Pass	\$ 1,342,913	398,997	\$ 239,162	\$ 135,950	\$ 129,383	\$ 283,326	\$ 490,331	\$ 3,020,062
Special Mention	9,941	8,154	5,198	764	1,376	5,619	5,955	37,007
Substandard	4,709	12,814	-	1,490	302	5,442	5,502	30,259
Substandard-Nonaccrual	1,723	1,626	37	-	-	74	-	3,460
Grand Total	<u>\$ 1,359,286</u>	<u>421,591</u>	<u>\$ 244,397</u>	<u>\$ 138,204</u>	<u>\$ 131,061</u>	<u>\$ 294,461</u>	<u>\$ 501,788</u>	<u>\$ 3,090,788</u>

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The amortized cost basis of collateral-dependent loans at December 31, 2022 and December 31, 2021 was \$324,000 and \$1,028,000, respectively, and were secured by business assets.

When management determines that foreclosures are probable, expected credit losses for collateral-dependent loans are based on the fair value of the collateral at the reporting date, adjusted for selling costs as appropriate. For loans which foreclosure is not probable, but for which repayment is expected to be provided substantially through the operation or sale of the collateral and the borrower is experiencing financial difficulty, management has elected the practical expedient under ASC 326 to estimate expected credit losses based on the fair value of collateral, adjusted for selling costs as appropriate. The class of loan represents the primary collateral type associated with the loan. Significant quarter over quarter changes are reflective of changes in nonaccrual status and not necessarily associated with credit quality indicators like appraisal value.

The book balance of troubled debt restructurings at December 31, 2022 was less than \$1,000. The book balance of troubled debt restructurings at December 31, 2021 was \$500,000, which included \$372,000 of nonaccrual loans and \$128,000 of accruing loans. There were no specific reserves established with respect to these loans as of December 31, 2022, and approximately \$290,000 in specific reserves were established with respect to these loans as of December 31, 2021. As of December 31, 2022 and December 31, 2021 respectively, the Company had no additional amounts committed on any loan classified as a troubled debt restructuring.

There were no loans modified as a troubled debt restructuring during the year ended December 31, 2022. There was one new loan with total recorded investment of \$3,000 that was modified as a troubled debt restructuring during the year ended December 31, 2021.

The following table presents loans by class modified as troubled debt restructurings for the periods indicated:

Troubled Debt Restructurings:	During the Year Ended December 31, 2021		
	Number of Contracts	Pre-modification Outstanding Recorded Investment (Dollars in thousands)	Post-modification Outstanding Recorded Investment
Commercial	1	\$ 3	\$ 3
Total	<u>1</u>	<u>\$ 3</u>	<u>\$ 3</u>

A loan is considered to be in payment default when it is 30 days contractually past due under the modified terms. There were no defaults on troubled debt restructurings, within twelve months following the modification, during the years ended December 31, 2022 and 2021.

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

5) Loan Servicing

At December 31, 2022, 2021, and 2020, the Company serviced SBA loans sold to the secondary market of approximately \$64,819,000, \$73,256,000, and \$77,973,000, respectively.

Servicing assets represent the servicing spread generated from the sold guaranteed portions of SBA loans. The weighted average servicing rate for all loans serviced was 1.10%, 1.11%, and 1.12% at December 31, 2022, 2021, and 2020, respectively.

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Servicing rights are included in “accrued interest receivable and other assets” on the consolidated balance sheets. Activity for loan servicing rights follows:

	<u>2022</u>	<u>2021</u>	<u>2020</u>
	(Dollars in thousands)		
Beginning of year balance	\$ 655	\$ 531	\$ 583
Additions	124	384	213
Amortization	(230)	(260)	(265)
End of year balance	<u>\$ 549</u>	<u>\$ 655</u>	<u>\$ 531</u>

There was no valuation allowance for servicing rights at December 31, 2022, 2021, and 2020, because the estimated fair value of the servicing rights was greater than the carrying value. The estimated fair value of loan servicing rights was \$813,000, \$1,101,000, and \$1,172,000, at December 31, 2022, 2021, and 2020, respectively. The fair value of servicing rights at December 31, 2022, was estimated using a weighted average constant prepayment rate (“CPR”) assumption of 15.12%, and a weighted average discount rate assumption of 20.75%. The fair value of servicing rights at December 31, 2021, was estimated using a weighted average CPR assumption of 13.40%, and a weighted average discount rate assumption of 13.88%.

The fair value of servicing rights at December 31, 2020, was estimated using a weighted average CPR assumption of 14.65%, and a weighted average discount rate assumption of 12.91%.

The weighted average discount rate and CPR assumptions used to estimate the fair value of the I/O strip receivables are the same as for the servicing rights. Management reviews the key economic assumptions used to estimate the fair value of I/O strip receivables on a quarterly basis. The fair value of the I/O strip can be adversely impacted by a significant increase in either the prepayment speed of the portfolio or the discount rate.

I/O strip receivables are included in “accrued interest receivable and other assets” on the consolidated balance sheets. Activity for I/O strip receivables follows:

	<u>2022</u>	<u>2021</u>	<u>2020</u>
	(Dollars in thousands)		
Beginning of year balance	\$ 221	\$ 305	\$ 503
Unrealized loss	(69)	(84)	(198)
End of year balance	<u>\$ 152</u>	<u>\$ 221</u>	<u>\$ 305</u>

6) Premises and Equipment

Premises and equipment at year-end were as follows:

	<u>2022</u>	<u>2021</u>
	(Dollars in thousands)	
Building	\$ 3,508	\$ 3,508
Land	2,900	2,900
Furniture and equipment	13,812	13,041
Leasehold improvements	5,597	5,441
	25,817	24,890
Accumulated depreciation and amortization	(16,516)	(15,251)
Premises and equipment, net	<u>\$ 9,301</u>	<u>\$ 9,639</u>

Depreciation and amortization expense was \$1,121,000, \$1,072,000, and \$951,000, in 2022, 2021, and 2020, respectively.

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7) Leases

As of December 31, 2022 and December 31, 2021, operating lease right-of-use (“ROU”) assets, included in other assets and lease liabilities, included in other liabilities, totaled \$33,031,000 and \$34,879,000, respectively.

The following table presents the quantitative information for the Company’s leases:

	Year Ended December 31,	
	2022	2021
(Dollars in thousands)		
Operating Lease Cost (Cost resulting from lease payments)	\$ 6,625	\$ 6,533
Operating Lease - Operating Cash Flows (Fixed Payments)	\$ 4,948	\$ 5,011
Operating Lease - ROU assets	\$ 33,031	\$ 34,879
Operating Lease - Liabilities	\$ 33,031	\$ 34,879
Weighted Average Lease Term - Operating Leases	6.60 years	7.37 years
Weighted Average Discount Rate - Operating Leases	4.49%	4.49%

The following maturity analysis shows the undiscounted cash flows due on the Company’s operating lease liabilities:

	(Dollars in thousands)
2023	\$ 6,351
2024	6,006
2025	5,459
2026	4,903
2027	4,730
Thereafter	10,988
Total undiscounted cash flows	<u>38,437</u>
Discount on cash flows	(5,406)
Total lease liability	<u>\$ 33,031</u>

8) Goodwill and Other Intangible Assets

Goodwill

At December 31, 2022, the carrying value of goodwill was \$167,631,000, which included \$13,044,000 of goodwill related to its acquisition of Bay View Funding, \$32,619,000 from its acquisition of Focus Business Bank, \$13,819,000 from its acquisition of Tri-Valley Bank, \$24,271,000 from its acquisition of United American Bank and \$83,878,000 from its acquisition of Presidio Bank.

Goodwill impairment exists when a reporting unit’s carrying value exceeds its fair value, which is determined through a qualitative assessment whether it is more likely than not that the fair value of equity of the reporting unit exceeds the carrying value (“Step Zero”). If the qualitative assessment indicates it is more likely than not that the fair value of equity of a reporting unit is less than book value, then a quantitative impairment test is required. The quantitative assessment identifies if a reporting unit fair value is less than its carrying value. If it is, then the Company will recognize goodwill impairment equal to the difference between the carrying amount of the reporting unit and its fair value, not to exceed the carrying amount of goodwill.

The Company completed its annual goodwill impairment analysis as of November 30, 2022 with the assistance of an independent valuation firm. The goodwill related to the acquisition of Bay View Funding was tested separately for impairment under this analysis. No events or circumstances since the November 30, 2022 annual impairment test were noted that would indicate it was more likely than not a goodwill impairment exists, for either the Company’s banking or factoring reporting units.

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The following table summarizes the carrying amount of goodwill by segment for the periods indicated:

	December 31, 2022	December 31, 2021
	(Dollars in thousands)	
	Banking	\$ 154,587
Factoring	13,044	13,044
Total Goodwill	<u>\$ 167,631</u>	<u>\$ 167,631</u>

Other Intangible Assets

The Company's intangible assets are summarized as follows for the periods indicated:

	December 31, 2022		
	Gross Carrying Amount	Accumulated Amortization	Remaining Carrying Amount
	(Dollars in thousands)		
Core deposit intangibles	\$ 25,023	\$ (14,429)	\$ 10,594
Customer relationship and brokered relationship intangibles	1,900	(1,551)	349
Below market leases	110	(20)	90
Total	<u>\$ 27,033</u>	<u>\$ (16,000)</u>	<u>\$ 11,033</u>

	December 31, 2021		
	Gross Carrying Amount	Accumulated Amortization	Remaining Carrying Amount
	(Dollars in thousands)		
Core deposit intangibles	\$ 25,023	\$ (11,982)	\$ 13,041
Customer relationship and brokered relationship intangibles	1,900	(1,361)	539
Below market leases	110	(22)	88
Total	<u>\$ 27,033</u>	<u>\$ (13,365)</u>	<u>\$ 13,668</u>

Estimated amortization expense for each of the next five years and thereafter is as follows:

Year	Core Deposit Intangible	Customer & Brokered Relationship Intangible	Below/ (Above) Market Lease	Total Amortization Expense
		(Dollars in thousands)		
2023	2,217	190	(2)	2,405
2024	2,023	159	5	2,187
2025	1,795	—	18	1,813
2026	1,512	—	18	1,530
2027	1,438	—	18	1,456
Thereafter	1,609	—	33	1,642
	<u>\$ 10,594</u>	<u>\$ 349</u>	<u>\$ 90</u>	<u>\$ 11,033</u>

Impairment testing of the intangible assets is performed at the individual asset level. Impairment exists if the carrying amount of the asset is not recoverable and exceeds its fair value at the date of the impairment test. For intangible assets, estimates of expected future cash flows (cash inflows less cash outflows) that are directly associated with an intangible asset are used to determine the fair value of that asset. Management makes certain estimates and assumptions in determining the expected future cash flows from core deposit and customer relationship intangibles including account attrition, expected lives, discount rates, interest rates, servicing costs and other factors. Significant changes in these estimates and assumptions could adversely impact the valuation of these intangible assets. If an impairment loss exists, the carrying amount of the intangible asset is adjusted to a new cost basis. The new cost basis is then amortized over the remaining useful life of the asset. Based on its assessment, management concluded that there was no impairment of intangible assets at December 31, 2022 and December 31, 2021.

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9) Deposits

The following table presents the scheduled maturities of all time deposits for the periods indicated:

	(Dollars in thousands)
2023	\$ 133,517
2024	8,513
2025	1,283
2026	274
2027	91
Thereafter	280
Total	\$ 143,958

Time deposits of \$250,000 and over were \$108,192,000 and \$94,700,000 at December 31, 2022 and 2021, respectively. At December 31, 2022, Certificate of Deposit Account Registry Service (“CDARS”) deposits totaled \$30,374,000 which were comprised of interest-bearing demand deposits of \$26,861,000 and money market deposits of \$192,000, (which have no scheduled maturity date, and therefore, are excluded from the table above), and time deposits of \$3,321,000, (which are included in the table above). At December 31, 2021, CDARS deposits totaled \$38,271,000, which were comprised of interest-bearing demand deposits of \$30,858,000 and money market deposits of \$1,013,000, and time deposits of \$6,400,000. The CDARS program allows customers with deposits in excess of FDIC-insured limits to obtain full coverage on time deposits through a network of banks within the CDARS program. Deposits gathered through these programs are not considered brokered deposits under current regulatory reporting guidelines.

Deposits from executive officers, directors, and their affiliates were \$712,000 and \$766,000 at December 31, 2022 and 2021, respectively.

10) Borrowing Arrangements

Federal Home Loan Bank Borrowings, Federal Reserve Bank Borrowings, and Available Lines of Credit

HBC maintains a collateralized line of credit with the FHLB of San Francisco. Under this line, the Company can borrow from the FHLB on a short-term (typically overnight) or long-term (over one year) basis. As of December 31, 2022, and December 31, 2021, HBC had no overnight borrowings from the FHLB. HBC had \$254,243,000 of loans and \$1,085,000 of securities pledged to the FHLB as collateral on a line of credit of \$162,631,000 at December 31, 2022, none of which was outstanding. HBC had \$280,748,000 of loans and \$1,551,000 of securities and pledged to the FHLB as collateral on a line of credit of \$205,631,000 at December 31, 2021, none of which was outstanding.

HBC can also borrow from the FRB’s discount window. HBC had approximately \$1,000,207,000 of loans pledged to the FRB as collateral on an available line of credit of approximately \$676,878,000 at December 31, 2022, none of which was outstanding. HBC had approximately \$1,008,601,000 of loans pledged to the FRB as collateral on an available line of credit of approximately \$567,873,000 at December 31, 2021, none of which was outstanding.

At December 31, 2022, HBC had Federal funds purchase arrangements available of \$80,000,000. There were no Federal funds purchased outstanding at December 31, 2022 and 2021.

HCC has a \$20,000,000 line of credit with a correspondent bank, of which none was outstanding at December 31, 2022 and 2022.

HBC may also utilize securities sold under repurchase agreements to manage our liquidity position. There were no securities sold under agreements to repurchase at December 31, 2022, and 2021.

Subordinated Debt

On May 11, 2022, the Company completed a private placement offering of \$40,000,000 aggregate principal amount of its 5.00% fixed-to-floating rate subordinated notes due May 15, 2032 (“Sub Debt due 2032”). The Company

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used the net proceeds of the Sub Debt due 2032 for general corporate purposes, including the repayment on June 1, 2022 of the Company's \$40,000,000 aggregate principal amount of 5.25% fixed-to-floating rate subordinated notes due June 1, 2027 ("Sub Debt due 2027"). The Sub Debt due 2032, net of unamortized issuance costs of \$650,000, totaled \$39,350,000 at December 31, 2022, and qualifies as Tier 2 capital for the Company under the guidelines established by the Federal Reserve Bank. The debt issuance costs are amortized on a straight line basis through the maturity date of the subordinated notes.

On May 26, 2017, the Company completed an underwritten public offering of \$40,000,000 aggregate principal amount of its Sub Debt due 2027. The Sub Debt due 2027 had a fixed interest rate of 5.25% per year through June 1, 2022. On June 1, 2022, the Company completed the redemption of all of its outstanding \$40,000,000 of Sub Debt due 2027, prior to resetting to a floating rate. The Sub Debt due 2027 was redeemed pursuant to the terms of the Subordinated Indenture, as supplemented by the First Supplemental Indenture, each dated as of May 26, 2017, between the Company and Wilmington Trust, National Association, as Trustee, at the redemption price of 100% of its principal amount, plus accrued and unpaid interest of \$1,100,000.

11) Income Taxes

Income tax expense consisted of the following for the year ended December 31, as follows:

	<u>2022</u>	<u>2021</u>	<u>2020</u>
	(Dollars in thousands)		
Currently payable tax:			
Federal	\$ 18,994	\$ 10,207	\$ 9,630
State	8,798	7,988	5,828
Total currently payable	<u>27,792</u>	<u>18,195</u>	<u>15,458</u>
Deferred tax expense (benefit):			
Federal	(1,237)	1,175	(932)
State	1,256	(1,200)	(757)
Total deferred tax	<u>19</u>	<u>(25)</u>	<u>(1,689)</u>
Income tax expense	<u><u>\$ 27,811</u></u>	<u><u>\$ 18,170</u></u>	<u><u>\$ 13,769</u></u>

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

	<u>2022</u>	<u>2021</u>	<u>2020</u>
Statutory Federal income tax rate	21.0 %	21.0 %	21.0 %
State income taxes, net of federal tax benefit	8.4 %	8.1 %	8.2 %
Low income housing credits, net of investment losses	(0.2)%	(0.3)%	(0.5)%
Increase in cash surrender value of life insurance	(0.4)%	(0.6)%	(0.8)%
Stock option/restricted stock windfall tax benefit	(0.1)%	(0.2)%	0.6 %
Non-taxable interest income	(0.2)%	(0.5)%	(0.8)%
Split-dollar term insurance	0.0 %	0.1 %	0.1 %
ISO stock exercise	0.0 %	(0.1)%	0.0 %
Other, net	1.0 %	0.1 %	0.3 %
Effective tax rate	<u><u>29.5 %</u></u>	<u><u>27.6 %</u></u>	<u><u>28.1 %</u></u>

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Deferred tax assets and liabilities that result from the tax effects of temporary differences between the carrying amount of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes at December 31, are as follows:

	2022 (Dollars in thousands)	2021 (Dollars in thousands)
Deferred tax assets:		
Allowance for credit losses on loans	\$ 14,171	\$ 12,716
Lease accounting	9,703	10,245
Defined postretirement benefit obligation	7,585	9,934
Securities available-for-sale	4,690	—
Accrued expenses	3,440	2,681
State income taxes	1,924	1,164
Federal net operating loss carryforwards	1,719	2,206
Premises and equipment	1,677	2,173
Stock compensation	1,363	1,632
California net operating loss carryforwards	1,106	1,489
Nonaccrual interest	174	67
Split-dollar life insurance benefit plan	49	84
Other	201	869
Total deferred tax assets	47,802	45,260
Deferred tax liabilities:		
Lease accounting	(9,703)	(10,245)
Loan fees	(2,304)	(2,174)
Intangible liabilities	(1,940)	(1,916)
Prepaid expenses	(1,304)	(972)
FHLB stock	(156)	(166)
I/O strips	(40)	(60)
Securities available-for-sale	—	(823)
Other	(179)	(147)
Total deferred tax liabilities	(15,626)	(16,503)
Net deferred tax assets	\$ 32,176	\$ 28,757

At December 31, 2022, the Company's federal net operating loss ("NOL") carryforwards were \$8,186,000 and the Company's California net operating loss carryforwards were \$13,452,000. These amounts are attributable to the prior merger transactions. The realization of these NOL carryforwards for Federal and State tax purposes are limited on the amount of net operating losses that can be utilized annually under the current tax law. The above NOL carryforwards are presented net of the losses that will expire unutilized under current tax law. Since the NOL carryforwards are already presented net of the amounts that will expire by operation of current tax law, there is no need for a valuation allowance as the Company fully expects to utilize the amounts disclosed.

Under generally accepted accounting principles, a valuation allowance is required if it is "more likely than not" that a deferred tax asset will not be realized. The determination of the realizability of the deferred tax assets is highly subjective and dependent upon judgment concerning management's evaluation of both positive and negative evidence, including forecasts of future income, cumulative losses, applicable tax planning strategies, and assessments of current and future economic and business conditions. As of December 31, 2022 and 2021 the Company's recorded amount of uncertain tax positions was not considered significant for financial reporting and the Company does not expect this amount to significantly increase or decrease in the next twelve months.

At December 31, 2022 and December 31, 2021, the Company had net deferred tax assets of \$32,176,000 and \$28,757,000, respectively. At December 31, 2022 and December 31, 2021, the Company determined that a valuation allowance for deferred tax assets was not necessary.

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The Company and its subsidiaries are subject to U.S. Federal income tax as well as income tax of the State of California. The Company is no longer subject to examination by Federal and state taxing authorities for years before 2019, and by the State of California taxing authority for years before 2018.

The following table reflects the carrying amounts of the low income housing investments included in accrued interest receivable and other assets, and the future commitments included in accrued interest payable and other liabilities for the periods indicated:

	December 31, 2022	December 31, 2021
	(Dollars in thousands)	
Low income housing investments	\$ 3,537	\$ 4,380
Future commitments	\$ 523	\$ 568

The Company expects \$27,000 of the future commitments to be paid in 2023, and \$498,000 in 2024 through 2026.

For tax purposes, the Company recognized low income housing tax credits of \$839,000 for the years ended December 31, 2022 and December 31, 2021, respectively, and low income housing investment expense of \$842,000 and \$866,000, respectively. The Company recognizes low income housing investment expenses as a component of income tax expense.

12) Equity Plan

The Company maintained an Amended and Restated 2004 Equity Plan (the “2004 Plan”) for directors, officers, and key employees. The 2004 Plan was terminated on May 23, 2013. The Company’s shareholders approved the 2013 Equity Incentive Plan (the “2013 Plan”). The equity plans provide for the grant of incentive and nonqualified stock options and restricted stock. The equity plans provide that the option price for both incentive and nonqualified stock options will be determined by the Board of Directors at no less than the fair value at the date of grant. Options granted vest on a schedule determined by the Board of Directors at the time of grant. Generally options vest over four years. All options expire no later than ten years from the date of grant. Restricted stock is subject to time vesting. The 2013 Plan will terminate at the 2023 Annual Shareholders Meeting to be held May 25, 2023. The Company intends to propose a new 2023 Equity Incentive Plan at the 2023 Annual Shareholders Meeting. All equity awards outstanding under the 2013 Plan remain outstanding subject to the terms of the respective award agreement. In 2022, the Company granted 387,000 shares of nonqualified stock options and 238,811 shares of restricted stock subject to time vesting requirements. There were 1,475,594 shares available for the issuance of equity awards under the 2013 Plan as of December 31, 2022.

Stock option activity under the equity plans is as follows:

Total Stock Options	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value
Outstanding at January 1, 2022	2,584,632	\$ 10.00		
Granted	387,000	\$ 11.12		
Exercised	(305,880)	\$ 6.70		
Forfeited or expired	(138,579)	\$ 12.34		
Outstanding at December 31, 2022	<u>2,527,173</u>	<u>\$ 10.44</u>	<u>5.52</u>	<u>\$ 7,497,913</u>
Vested or expected to vest	<u>2,375,543</u>		<u>5.52</u>	<u>\$ 7,048,038</u>
Exercisable at December 31, 2022	<u>1,900,047</u>		<u>4.48</u>	<u>\$ 6,333,749</u>

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Information related to the equity plans for each of the last three years:

	December 31,		
	2022	2021	2020
Intrinsic value of options exercised	\$ 1,674,072	\$ 1,543,711	\$ 2,258,245
Cash received from option exercise	\$ 2,049,587	\$ 1,469,255	\$ 1,713,737
Tax benefit realized from option exercises	\$ 180,414	\$ 153,745	\$ 63,124
Weighted average fair value of options granted	\$ 2.22	\$ 2.31	\$ 1.15

As of December 31, 2022, there was \$1,294,000 of total unrecognized compensation cost related to nonvested stock options granted under the equity plans. That cost is expected to be recognized over a weighted-average period of approximately 2.66 years.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model that uses the assumptions noted in the following table, including the weighted average assumptions for the option grants in each year.

	December 31,		
	2022	2021	2020
Expected life in months(1)	72	72	72
Volatility(1)	31 %	33 %	29 %
Weighted average risk-free interest rate(2)	2.89 %	1.10 %	0.53 %
Expected dividends(3)	4.68 %	4.32 %	5.71 %

- (1) The expected life of employee stock options represents the weighted average period the stock options are expected to remain outstanding based on historical experience. Volatility is based on the historical volatility of the stock price over the same period of the expected life of the option.
- (2) Based on the U.S. Treasury constant maturity interest rate with a term consistent with the expected life of the option granted.
- (3) Each grant's dividend yield is calculated by annualizing the most recent quarterly cash dividend and dividing that amount by the market price of the Company's common stock as of the grant date

The Company estimates the impact of forfeitures based on historical experience. Should the Company's current estimate change, additional expense could be recognized or reversed in future periods. The Company issues authorized shares of common stock to satisfy stock option exercises.

Restricted stock activity under the equity plans is as follows:

Total Restricted Stock Award	Number of Shares	Weighted Average Grant Date Fair Value
Nonvested shares at January 1, 2022	298,566	\$ 11.03
Granted	238,811	\$ 11.16
Vested	(252,081)	\$ 11.81
Forfeited or expired	(31,805)	\$ 11.23
Nonvested shares at December 31, 2022	<u>253,491</u>	<u>\$ 11.05</u>

As of December 31, 2022, there was \$1,881,000 of total unrecognized compensation cost related to nonvested restricted stock awards granted under the 2013 Plan. The cost is expected to be recognized over a weighted-average period of approximately 1.90 years.

Total compensation cost for the 2004 Plan and 2013 Plan charged against income was \$3,178,000, \$2,519,000,

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\$2,248,000, for 2022, 2021, and 2020, respectively. The total income tax (benefit) expense was (\$94,000), (\$155,000), and \$301,000 for the years ended December 31, 2022, and 2021, and 2020, respectively.

13) Benefit Plans

401(k) Savings Plan

The Company offers a 401(k) savings plan that allows employees to contribute up to a maximum percentage of their compensation, as established by the Internal Revenue Code. The Company made a discretionary matching contribution of up to \$3,000 for each employee's contributions in 2022 and 2021. Contribution expense was \$942,000, \$944,000, and \$942,000 in 2022, and 2021 and 2020, respectively.

Employee Stock Ownership Plan

The Company sponsors a non-contributory employee stock ownership plan ("ESOP"). To participate in this plan, an employee must have worked at least 1,000 hours during the year and must be employed by the Company at year-end. Employer contributions to the ESOP are discretionary. Contributions to the ESOP have been suspended since 2010 and ESOP was "frozen" as of January 1, 2019. At December 31, 2022, the ESOP owned 91,343 shares of the Company's common stock.

Deferred Compensation Plan

The Company has a nonqualified deferred compensation plan for some of its employees. Under the deferred compensation plan, an employee may defer up to 100% of their bonus and 50% of their regular salary into a deferred account. Amounts deferred are invested in a portfolio of approved investment choices as directed by the employee. Amounts deferred by employees to the deferred compensation plan will be distributed at a future date that they have selected or upon termination of employment. There were ten employees who elected to participate in the deferred compensation plan during both 2022 and 2021.

Nonqualified Defined Benefit Pension Plan

The Company has a supplemental retirement plan ("SERP") covering some current and some former key executives and directors. The SERP is an unfunded, nonqualified defined benefit plan. The combined number of active and retired/terminated participants in the SERP was 50 at December 31, 2022. The defined benefit represents a stated amount for key executives and directors that generally vests over nine years and is reduced for early retirement. The projected benefit obligation is included in "Accrued interest payable and other liabilities" on the consolidated balance sheets. The SERP has no assets and the projected benefit obligation is unfunded. The measurement date of the SERP is December 31.

The following table sets forth the SERP's status at December 31:

	2022 (Dollars in thousands)	2021 (Dollars in thousands)
Change in projected benefit obligation:		
Projected benefit obligation at beginning of year	\$ 33,179	\$ 35,404
Service cost	347	480
Actuarial gain	(7,065)	(917)
Interest cost	865	759
Benefits paid	(1,526)	(2,547)
Projected benefit obligation at end of year	<u>\$ 25,800</u>	<u>\$ 33,179</u>
Amounts recognized in accumulated other comprehensive loss:		
Net actuarial loss	<u>\$ 2,371</u>	<u>\$ 7,668</u>

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Weighted-average assumptions used to determine the benefit obligation at year-end:

	<u>2022</u>	<u>2021</u>
Discount rate	5.17 %	2.66 %
Rate of compensation increase	N/A	N/A

Estimated benefit payments over the next ten years, which reflect anticipated future events, service and other assumptions, are as follows:

Year	Estimated Benefit Payments (Dollars in thousands)
2023	\$ 1,654
2024	1,969
2025	2,059
2026	2,179
2027	2,316
2028 to 2032	12,131

The components of pension cost for the SERP follow:

	Year Ended December 31,	
	<u>2022</u>	<u>2021</u>
Components of net periodic benefit cost:		
Service cost	\$ 347	\$ 480
Interest cost	865	759
Amortization of prior service cost	—	100
Amortization of net actuarial loss	455	543
Net periodic benefit cost	\$ 1,667	\$ 1,882
Amount recognized in other comprehensive income	\$ 5,297	\$ 1,098

The components of net periodic benefit cost other than the service cost component are included in the line item “other noninterest expense” in the Consolidated Statements of Income. The estimated net actuarial loss and prior service cost for the SERP that will be amortized from Accumulated Other Comprehensive Loss into net periodic benefit cost over the next fiscal year are \$53,000 as of December 31, 2022.

Net periodic benefit cost for the years ended December 31, 2022 and 2021 were determined using the following assumption:

	<u>2022</u>	<u>2021</u>
Discount rate	2.66 %	2.26 %
Rate of compensation increase	N/A	N/A

Split-Dollar Life Insurance Benefit Plan

The Company maintains life insurance policies for some current and some former directors and officers that are subject to split-dollar life insurance agreements, some of which continues after the participant’s employment and retirement. The policies acquired from Focus and Presidio do not include a post retirement benefit. All participants are fully vested in their split-dollar life insurance benefits. The accrued benefit liability for the split-dollar insurance agreements represents either the present value of the future death benefits payable to the participants’ beneficiaries or the present value of the estimated cost to maintain term life insurance, depending on the contractual terms of the participant’s underlying agreement.

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The split-dollar life insurance projected benefit obligation is included in “Accrued interest payable and other liabilities” on the consolidated balance sheets. The measurement date of the split-dollar life insurance benefit plan is December 31.

The following sets forth the funded status of the split dollar life insurance benefits:

	December 31, 2022	December 31, 2021
	(Dollars in thousands)	
Change in projected benefit obligation:		
Projected benefit obligation at beginning of year	\$ 9,244	\$ 9,689
Interest cost	246	219
Actuarial loss	(2,430)	(664)
Projected benefit obligation at end of period	\$ 7,060	\$ 9,244

Amounts recognized in accumulated other comprehensive loss at December 31 consist of:

	December 31, 2022	December 31, 2021
	(Dollars in thousands)	
Net actuarial loss		
Net actuarial loss	\$ 2,301	\$ 4,601
Prior transition obligation	790	879
Accumulated other comprehensive loss	\$ 3,091	\$ 5,480

Weighted-average assumption used to determine the benefit obligation at year-end follow:

	2022	2021
Discount rate	5.17 %	2.66 %

Components of net periodic benefit cost during the year are:

	Year Ended December 31,	
	2022	2021
Amortization of prior transition obligation and actuarial losses		
Amortization of prior transition obligation and actuarial losses	\$ (41)	\$ (4)
Interest cost	246	219
Net periodic benefit cost	\$ 205	\$ 215
 Amount recognized in other comprehensive income	 \$ 2,389	 \$ 660

The estimated net actuarial loss and prior transition obligation for the split-dollar life insurance benefit plan that will be amortized from accumulated other comprehensive loss into net periodic benefit cost over the next fiscal year are (\$191,000) and (\$41,000) as of December 31, 2022 and 2021, respectively.

Weighted-average assumption used to determine the net periodic benefit cost:

	2022	2021
Discount rate	2.66 %	2.26 %

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14) Fair Value

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

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

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

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

Financial Assets and Liabilities Measured on a Recurring Basis

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

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

	Balance	Fair Value Measurements Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
		(Dollars in thousands)		
Assets at December 31, 2022				
Available-for-sale securities:				
U.S. Treasury	\$ 418,474	\$ 418,474	\$ —	\$ —
Agency mortgage-backed securities	71,122	—	71,122	—
I/O strip receivables	152	—	152	—
Assets at December 31, 2021				
Available-for-sale securities:				
Agency mortgage-backed securities	\$ 102,252	\$ —	\$ 102,252	\$ —
I/O strip receivables	221	—	221	—

Assets and Liabilities Measured on a Non-Recurring Basis

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

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Foreclosed assets are valued at the time the loan is foreclosed upon and the asset is transferred to foreclosed assets. The fair value is based primarily on third party appraisals, less costs to sell. The appraisals may utilize a single valuation approach or a combination of approaches including the comparable sales and income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are typically significant and result in a Level 3 classification of the inputs for determining fair value. At December 31, 2022 and December 31, 2021, there were no foreclosed assets on the balance sheet.

Fair Value of Financial Instruments

The carrying amounts and estimated fair values of financial instruments at December 31, 2022 are as follows:

	Carrying Amounts	Estimated Fair Value				(Dollars in thousands)
		Quoted Prices in Active Markets for Identical Assets (Level 1)		Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
Assets:						
Cash and cash equivalents	\$ 306,603	\$ 306,603	\$ —	\$ —	\$ 306,603	
Securities available-for-sale	489,596	418,474	71,122	—	489,596	
Securities held-to-maturity, net	714,990	—	614,452	—	614,452	
Loans (including loans held-for-sale), net	3,253,494	—	2,456	3,080,485	3,082,941	
FHLB stock, FRB stock, and other investments	32,522	—	—	—	N/A	
Accrued interest receivable	15,047	1,328	1,836	11,883	15,047	
I/O strips receivables	152	—	152	—	152	
Liabilities:						
Time deposits	\$ 143,958	\$ —	\$ 144,702	\$ —	\$ 144,702	
Other deposits	4,245,646	—	4,245,646	—	4,245,646	
Subordinated debt	39,350	—	36,025	—	36,025	
Accrued interest payable	600	—	600	—	600	

The carrying amounts and estimated fair values of financial instruments at December 31, 2021 are as follows:

	Carrying Amounts	Estimated Fair Value				(Dollars in thousands)
		Quoted Prices in Active Markets for Identical Assets (Level 1)		Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
Assets:						
Cash and cash equivalents	\$ 1,306,216	\$ 1,306,216	\$ —	\$ —	\$ 1,306,216	
Securities available-for-sale	102,252	—	102,252	—	102,252	
Securities held-to-maturity, net	658,397	—	657,649	—	657,649	
Loans (including loans held-for-sale), net	3,046,403	—	2,367	3,061,558	3,063,925	
FHLB stock, FRB stock, and other investments	32,504	—	—	—	N/A	
Accrued interest receivable	10,781	—	1,719	9,062	10,781	
I/O strips receivables	221	—	221	—	221	
Liabilities:						
Time deposits	\$ 139,834	\$ —	\$ 140,086	\$ —	\$ 140,086	
Other deposits	4,619,578	—	4,619,578	—	4,619,578	
Subordinated debt	39,925	—	40,425	—	40,425	
Accrued interest payable	477	—	477	—	477	

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15) Commitments and Contingencies

Loss Contingencies

Within the ordinary course of our business, we are subject to private lawsuits, government audits, administrative proceedings and other claims. A number of these claims may exist at any given time, and some of the claims may be pled as class actions. We could be affected by adverse publicity and litigation costs resulting from such allegations, regardless of whether they are valid or whether we are legally determined to be liable. A summary of proceedings outstanding at December 31, 2022 follows:

D.C. Solar Related:

- In December 2020, Solar Eclipse Investment Fund III, et al v. Heritage Bank of Commerce, et al., was filed against the Bank, and others, in the Solano County Superior Court for the State of California. The case relates to the Bank's former deposit relationships with investment funds sponsored by D.C. Solar and affiliates (collectively "D.C. Solar"). D.C. Solar is a former customer that allegedly perpetrated a Ponzi scheme and declared bankruptcy. In October 2021, the court sustained the Bank's demurrer without leave to amend on all but two counts. Subsequently, the plaintiffs sought to overturn the court's ruling in favor of the Bank by filing a petition for a writ of mandate in the California Court of Appeals, where the petition was denied. On December 12, 2022, the court granted the Bank's motion for judgment on the pleadings on one of the two remaining counts. The Bank has filed a motion for summary judgment against one of the 26 plaintiffs on the one remaining count. We intend to vigorously defend this action.
- In December 2020, Solarmore Management Services, Inc. v. Jeff Carpooff et al., ("Solarmore") was filed as an amended complaint in the United States District Court for the Eastern District of California against the Bank, a former employee and other unrelated parties. The case arose out of the Bank's former deposit relationship with D.C. Solar and its sponsored investment funds. On February 4, 2022, Solarmore voluntarily dismissed the Bank without prejudice, but not the Bank's former employee. The Bank's former employee remains a party to the action.

Employee Related:

- In November 2020, a former and a then-current bank employee purporting to represent a class of Bank employees, alleged in a lawsuit that the Bank violated the California Labor Code and California Business and Professions Code, by failing to permit required meal and rest breaks, and by failing to provide accurate wage statements, among other claims. The lawsuit seeks unspecified penalties under the California Private Attorneys General Act ("PAGA") in addition to other monetary payments. Because the class/PAGA action alleges wage and hour claims, it is not covered by the Bank's insurance. In February 2021, the Bank was notified of a set of PAGA and potential class claims alleged by a third former and a then-current bank employee alleging the same claims. The third former employee/claimant is being added as a plaintiff to the previously filed class/PAGA action. We intend to vigorously defend this action.
- In October 2021 the third employee/claimant above referenced filed a lawsuit alleging race, color, gender, and sex discrimination; disability discrimination; discrimination against an employee making a CFRA claim, violation of the Equal Pay Act, retaliation, and related claims. We intend to vigorously defend this action.
- In September 2022 the Bank moved to compel arbitration in both cases; hearings were held in Alameda County Superior Court in early November and early December 2022. The motions in both cases were denied and the Bank appealed the rulings. Both cases are stayed pending appeal.

The Company makes a provision for a liability relating to legal matters when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, estimated settlements, legal rulings, advice of legal counsel and other information and events pertaining to a particular matter. The

outcomes of legal proceedings and other contingencies are, however, inherently unpredictable and subject to significant uncertainties. As a result, the Company is not able to reasonably estimate the amount or range of possible losses, including losses that could arise as a result of application of

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non-monetary remedies, with respect to the contingencies it faces, and the Company's estimates may not prove to be accurate.

At this time, we believe that the amount of reasonably possible losses resulting from final disposition of any pending lawsuits, audits, proceedings and claims will not have a material adverse effect individually or in the aggregate on our financial position, results of operations or liquidity. It is possible, however, that our future results of operations for a particular quarter or fiscal year could be impacted by changes in circumstances relating to lawsuits, proceedings or claims. Legal costs related to such claims are expensed as incurred.

Off-Balance Sheet Arrangements

In the normal course of business the Company makes commitments to extend credit to its customers as long as there are no violations of any conditions established in the contractual arrangements. These commitments are obligations that represent a potential credit risk to the Company, but are not reflected on the Company's consolidated balance sheets. Total unused commitments to extend credit were \$1,134,619,000 at December 31, 2022, compared to \$1,150,811,000 at December 31, 2021. Unused commitments represented 34% outstanding gross loans at December 31, 2022, and 37% at December 31, 2021.

The effect on the Company's revenues, expenses, cash flows and liquidity from the unused portion of the commitments to provide credit cannot be reasonably predicted because there is no certainty that lines of credit and letters of credit will ever be fully utilized. The following table presents the Company's commitments to extend credit for the periods indicated:

	December 31, 2022			December 31, 2021		
	Fixed Rate	Variable Rate	Total (Dollars in thousands)	Fixed Rate	Variable Rate	Total
Unused lines of credit and commitments to make loans	\$ 87,348	\$ 1,036,847	\$ 1,124,195	\$ 119,071	\$ 1,015,588	\$ 1,134,659
Standby letters of credit	1,565	8,859	10,424	3,084	13,068	16,152
	<u>\$ 88,913</u>	<u>\$ 1,045,706</u>	<u>\$ 1,134,619</u>	<u>\$ 122,155</u>	<u>\$ 1,028,656</u>	<u>\$ 1,150,811</u>

For the year ended December 31, 2022, there was an increase of \$5,000 to the allowance for credit losses on loans for the Company's off-balance sheet credit exposures, compared to the year ended December 31, 2021. The allowance for losses for the Company's off-balance sheet credit exposures was \$820,000 and \$815,000 at December 31, 2022 and December 31, 2021, respectively. The increase in the allowance for credit losses for off-balance sheet credit exposures for the year ended December 31, 2022 was driven by an increase in loss factors as a result of a slowing economic outlook, partially offset by a decrease in loan commitments.

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16) Earnings Per Share

Basic earnings per common share is computed by dividing net income, less dividends and discount accretion on preferred stock, by the weighted average common shares outstanding. Diluted earnings per share reflect potential dilution from outstanding stock options using the treasury stock method. There were 1,325,948 stock options for the year ended December 31, 2022, considered to be antidilutive and excluded from the computation of diluted earnings per share. There were 1,058,250 stock options for the year ended December 31, 2021, considered to be antidilutive and excluded from the computation of diluted earnings per share. There were 1,524,757 stock options for the year ended December 31, 2020, considered to be antidilutive and excluded from the computation of diluted earnings per share. A reconciliation of these factors used in computing basic and diluted earnings per common share is as follows:

	Year Ended December 31,		
	2022	2021	2020
	(Dollars in thousands, except per share amounts)		
Net income	\$ 66,555	\$ 47,700	\$ 35,299
Weighted average common shares outstanding for basic earnings per common share	60,602,962	60,133,821	59,478,343
Dilutive potential common shares	487,328	555,241	690,796
Shares used in computing diluted earnings per common share	<u>61,090,290</u>	<u>60,689,062</u>	<u>60,169,139</u>
Basic earnings per share	\$ 1.10	\$ 0.79	\$ 0.59
Diluted earnings per share	\$ 1.09	\$ 0.79	\$ 0.59

17) Capital Requirements

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

The Company's consolidated capital ratios and the HBC's capital ratios exceeded the regulatory guidelines for a well-capitalized financial institution under the Basel III regulatory requirements at December 31, 2022. There are no conditions or events since December 31, 2022, that management believes have changed the categorization of the Company or HBC as "well-capitalized."

As permitted by the interim final rule issued on March 27, 2020 by our federal regulatory agency, we elected the option to delay the estimated impact of the adoption of the CECL Standard in our regulatory capital for two years. This two-year delay is in addition to the three-year transition period the agency had already made available. The adoption delayed the effects of CECL on our regulatory capital through the end of 2021. The effects are being phased-in over a three-year period from January 1, 2022 through December 31, 2024, with 75% recognized in 2022, 50% recognized in 2023, and 25% recognized in 2024. Under the interim final rule, the amount of adjustments to regulatory capital deferred until the phase-in period includes both the initial impact of adoption of the CECL Standard at January 1, 2020 and 25% of subsequent changes in our allowance for credit losses during each quarter of the two-year period ending December 31, 2021.

Quantitative measures established by regulation to help ensure capital adequacy require the Company and HBC to maintain minimum amounts and ratios (set forth in the tables below) of total, Tier 1 capital, and common equity Tier 1 capital (as defined in the regulations) to risk weighted assets (as defined), and of Tier 1

capital to average assets (as defined). Management believes that, as of December 31, 2022 and December 31, 2021, the Company and HBC met all capital adequacy guidelines to which they were subject.

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The Company's consolidated capital amounts and ratios are presented in the following table, together with capital adequacy requirements, under the Basel III regulatory requirements as of December 31, 2022, and December 31, 2021.

	Actual		Required For Capital Adequacy Purposes Under Basel III	
	Amount	Ratio (Dollars in thousands)	Amount	Ratio ⁽¹⁾
As of December 31, 2022				
Total Capital (to risk-weighted assets)	\$ 554,810	14.8 %	\$ 393,461	10.5 %
Tier 1 Capital (to risk-weighted assets)	\$ 475,609	12.7 %	\$ 318,516	8.5 %
Common Equity Tier 1 Capital (to risk-weighted assets)	\$ 475,609	12.7 %	\$ 262,307	7.0 %
Tier 1 Capital (to average assets)	\$ 475,609	9.2 %	\$ 207,852	4.0 %

(1) Includes 2.5% capital conservation buffer, except the Tier 1 Capital to average assets ratio.

	Actual		Required For Capital Adequacy Purposes Under Basel III	
	Amount	Ratio (Dollars in thousands)	Amount	Ratio ⁽¹⁾
As of December 31, 2021				
Total Capital (to risk-weighted assets)	\$ 506,209	14.4 %	\$ 369,711	10.5 %
Tier 1 Capital (to risk-weighted assets)	\$ 433,488	12.3 %	\$ 299,290	8.5 %
Common Equity Tier 1 Capital (to risk-weighted assets)	\$ 433,488	12.3 %	\$ 246,474	7.0 %
Tier 1 Capital (to average assets)	\$ 433,488	7.9 %	\$ 220,193	4.0 %

(1) Includes 2.5% capital conservation buffer, except the Tier 1 Capital to average assets ratio.

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HBC's actual capital amounts and ratios are presented in the following table, together with capital adequacy requirements, under the Basel III regulatory requirements as of December 31, 2022, and December 31, 2021.

	Actual		To Be Well-Capitalized Under Basel III PCA Regulatory Requirements		Required For Capital Adequacy Purposes Under Basel III	
	Amount	Ratio	Amount (Dollars in thousands)	Ratio	Amount	Ratio ⁽¹⁾
As of December 31, 2022						
Total Capital (to risk-weighted assets)	\$532,576	14.2 %	\$ 374,572	10.0 %	\$393,301	10.5 %
Tier 1 Capital (to risk-weighted assets)	\$492,725	13.2 %	\$ 299,658	8.0 %	\$318,387	8.5 %
Common Equity Tier 1 Capital (to risk-weighted assets)	\$492,725	13.2 %	\$ 243,472	6.5 %	\$262,201	7.0 %
Tier 1 Capital (to average assets)	\$492,725	9.5 %	\$ 259,740	5.0 %	\$207,792	4.0 %

(1) Includes 2.5% capital conservation buffer, except the Tier 1 Capital to average assets ratio.

	Actual		To Be Well-Capitalized Under Basel III PCA Regulatory Requirements		Required For Capital Adequacy Purposes Under Basel III	
	Amount	Ratio	Amount (Dollars in thousands)	Ratio	Amount	Ratio ⁽¹⁾
As of December 31, 2021						
Total Capital (to risk-weighted assets)	\$484,382	13.8 %	\$ 351,839	10.0 %	\$369,431	10.5 %
Tier 1 Capital (to risk-weighted assets)	\$451,586	12.8 %	\$ 281,471	8.0 %	\$299,063	8.5 %
Common Equity Tier 1 Capital (to risk-weighted assets)	\$451,586	12.8 %	\$ 228,695	6.5 %	\$246,287	7.0 %
Tier 1 Capital (to average assets)	\$451,586	8.2 %	\$ 275,109	5.0 %	\$220,087	4.0 %

(1) Includes 2.5% capital conservation buffer, except the Tier 1 Capital to average assets.

The Subordinated Debt, net of unamortized issuance costs, totaled \$39,350,000 at December 31, 2022, and qualifies as Tier 2 capital for the Company under the guidelines established by the Federal Reserve Bank.

Under California General Corporation Law, the holders of common stock are entitled to receive dividends when and as declared by the Board of Directors, out of funds legally available. The California Financial Code provides that a state licensed bank may not make a cash distribution to its shareholders in excess of the lesser of the following: (i) the bank's retained earnings; or (ii) the bank's net income for its last three fiscal years, less the amount of any distributions made by the bank to its shareholders during such period. However, a bank, with the prior approval of the Commissioner of the California Department of Financial Protection and Innovation ("DFPI") may make a distribution to its shareholders of an amount not to exceed the greater of (i) a bank's retained earnings; (ii) its net income for its last fiscal year; or (iii) its net income for the current fiscal year. Also with the prior approval of the Commissioner of the DFPI and the shareholders of the bank, the bank may make a distribution to its shareholders, as a reduction in capital of the bank. In the event that the Commissioner determines that the shareholders' equity of a bank is inadequate or that the making of a distribution by a bank would be unsafe or unsound, the Commissioner may order a bank to refrain from making such a proposed distribution. As of December 31, 2022, HBC would not be required to obtain regulatory approval, and the amount available for cash dividends is \$17,140,000. Similar restrictions applied

to the amount and sum of loan advances and other transfers of funds from HBC to the parent company. HBC distributed to HCC dividends of \$32,000,000 for both years ended

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December 31, 2022 and 2021.

18) Revenue Recognition

On January 1, 2018, the Company adopted ASU No. 2014-09 (*Topic 606*) and all subsequent ASUs that modified Topic 606. Topic 606 does not apply to revenue associated with financial instruments, including revenue from loans and securities. In addition, certain noninterest income streams such as fees associated with mortgage servicing rights, financial guarantees, gain on sale of securities, bank-owned life insurance, gain on sales of SBA loans, and certain credit card fees are also not in scope of the new guidance. Topic 606 is applicable to noninterest revenue streams such as deposit related fees, interchange fees, and merchant income. However, the recognition of these revenue streams did not change significantly upon adoption of Topic 606. Substantially all of the Company's revenue is generated from contracts with customers. The following noninterest income revenue streams are in-scope of Topic 606:

Service charges and fees on deposit accounts consist of account analysis fees (i.e., net fees earned on analyzed business and public checking accounts), monthly service fees, check orders, and other deposit account related fees. We sometimes charge customers fees that are not specifically related to the customer accessing its funds, such as account maintenance or dormancy fees. The amount of deposit fees assessed varies based on a number of factors, such as the type of customer and account, the quantity of transactions, and the size of the deposit balance. We charge, and in some circumstances do not charge, fees to earn additional revenue and influence certain customer behavior. An example would be where we do not charge a monthly service fee, or do not charge for certain transactions, for customers that have a high deposit balance. Deposit fees are considered either transactional in nature (such as wire transfers, nonsufficient fund fees, and stop payment orders) or non-transactional (such as account maintenance and dormancy fees). These fees are recognized as earned or as transactions occur and services are provided. Check orders and other deposit account related fees are largely transactional based and, therefore, the Company's performance obligation is satisfied, and related revenue recognized, at a point in time. Payment for service charges on deposit accounts is primarily received immediately or in the following month through a direct charge to customers' accounts.

The Company currently accounts for sales of foreclosed assets in accordance with Topic 360-20. In most cases the Company will seek to engage a real estate agent for the sale of foreclosed assets immediately upon foreclosure. However, in some cases, where there is clear demand for the property in question, the Company may elect to allow for a marketing period on no more than six months to attempt a direct sale of the property. We generally recognize the sale, and any associated gain or loss, of a real estate property when control of the property transfers. Any gains or losses from the sale are recorded to noninterest income/expense.

The following presents noninterest income, segregated by revenue streams in-scope and out-of-scope of Topic 606, for the periods indicated:

	Year Ended December 31,		
	2022	2021	2020
	(Dollars in thousands)		
Noninterest Income In-scope of Topic 606:			
Service charges and fees on deposit accounts	\$ 4,640	\$2,488	\$2,859
Gain on the disposition of foreclosed assets	—	—	791
Total noninterest income in-scope of Topic 606	4,640	2,488	3,650
Noninterest Income Out-of-scope of Topic 606	5,471	7,200	6,272
Total noninterest income	<u>\$10,111</u>	<u>\$9,688</u>	<u>\$9,922</u>

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19) Noninterest Expense

The following table indicates the various components of the Company's noninterest expense in each category for the periods indicated:

	Year Ended December 31,		
	2022	2021	2020
	(Dollars in thousands)		
Salaries and employee benefits	\$ 55,331	\$ 51,862	\$ 50,927
Occupancy and equipment	9,639	9,038	8,018
Professional fees	5,015	5,901	5,338
Insurance expense	4,958	3,270	2,286
Amortization of intangible assets	2,635	2,996	3,751
Data processing	2,482	2,146	2,770
Reserve for litigation	—	4,500	—
Other	14,799	13,364	16,421
Total noninterest expense	<u>\$ 94,859</u>	<u>\$ 93,077</u>	<u>\$ 89,511</u>

The following table presents the merger-related costs by category for the periods indicated:

	For the Year Ended		
	December 31,		
	2022	2021	2020
(Dollars in thousands)			
Salaries and employee benefits	\$ —	\$ —	\$ 356
Other	—	27	2,245
Total merger-related costs	<u>\$ —</u>	<u>\$ 27</u>	<u>\$ 2,601</u>

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20) Business Segment Information

The following presents the Company's operating segments. The Company operates through two business segments: Banking segment and Factoring segment. Transactions between segments consist primarily of borrowed funds. Intersegment interest expense is allocated to the Factoring segment based on the Company's prime rate and funding costs. The provision for credit losses on loans is allocated based on the segment's allowance for credit losses on loans determination which considers the effects of charge-offs. Noninterest income and expense directly attributable to a segment are assigned to it. Taxes are paid on a consolidated basis and allocated for segment purposes. The Factoring segment includes only factoring originated by Bay View Funding.

	Year Ended December 31, 2022		
	Banking ⁽¹⁾	Factoring	Consolidated
	(Dollars in thousands)		
Interest income	\$ 176,010	\$ 12,818	\$ 188,828
Intersegment interest allocations	1,441	(1,441)	—
Total interest expense	8,948	—	8,948
Net interest income	168,503	11,377	179,880
Provision for (recapture of) credit losses on loans	526	240	766
Net interest income after provision	167,977	11,137	179,114
Noninterest income	9,722	389	10,111
Noninterest expense	88,531	6,328	94,859
Intersegment expense allocations	524	(524)	—
Income before income taxes	89,692	4,674	94,366
Income tax expense	26,429	1,382	27,811
Net income	\$ 63,263	\$ 3,292	\$ 66,555
Total assets	\$ 5,062,943	\$ 94,637	\$ 5,157,580
Loans, net of deferred fees	\$ 3,219,287	\$ 79,263	\$ 3,298,550
Goodwill	\$ 154,587	\$ 13,044	\$ 167,631

(1) Includes the holding company's results of operations.

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	Year Ended December 31, 2021		
	Banking ⁽¹⁾	Factoring	Consolidated
	(Dollars in thousands)		
Interest income	\$ 141,772	\$ 11,484	\$ 153,256
Intersegment interest allocations	868	(868)	—
Total interest expense	7,131	—	7,131
Net interest income	135,509	10,616	146,125
Provision (recapture) for credit losses on loans	(2,926)	(208)	(3,134)
Net interest income after provision	138,435	10,824	149,259
Noninterest income	8,651	1,037	9,688
Noninterest expense	87,466	5,611	93,077
Intersegment expense allocations	410	(410)	—
Income before income taxes	60,030	5,840	65,870
Income tax expense	16,444	1,726	18,170
Net income	<u>\$ 43,586</u>	<u>\$ 4,114</u>	<u>\$ 47,700</u>
Total assets	\$ 5,424,350	\$ 75,059	\$ 5,499,409
Loans, net of deferred fees	\$ 3,034,097	\$ 53,229	\$ 3,087,326
Goodwill	\$ 154,587	\$ 13,044	\$ 167,631

(1) Includes the holding company's results of operations.

	Year Ended December 31, 2020		
	Banking ⁽¹⁾	Factoring	Consolidated
	(Dollars in thousands)		
Interest income	\$ 139,744	\$ 10,727	\$ 150,471
Intersegment interest allocations	923	(923)	—
Total interest expense	8,581	—	8,581
Net interest income	132,086	9,804	141,890
Provision for credit losses on loans	12,928	305	13,233
Net interest income after provision	119,158	9,499	128,657
Noninterest income	9,277	645	9,922
Noninterest expense ⁽²⁾	83,149	9,362	89,511
Intersegment expense allocations	404	(404)	—
Income before income taxes	45,690	3,378	49,068
Income tax expense	12,770	999	13,769
Net income	<u>\$ 32,920</u>	<u>\$ 2,379</u>	<u>\$ 35,299</u>
Total assets	\$ 4,567,239	\$ 66,875	\$ 4,634,114
Loans, net of deferred fees	\$ 2,572,060	\$ 47,201	\$ 2,619,261
Goodwill	\$ 154,587	\$ 13,044	\$ 167,631

(1) Includes the holding company's results of operations.

(2) The banking segment's noninterest expense includes merger-related costs of \$2,601,000.

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21) Parent Company only Condensed Financial Information

The condensed financial statements of Heritage Commerce Corp (parent company only) are as follows:

Condensed Balance Sheets

	December 31,	
	2022	2021
	(Dollars in thousands)	
Assets		
Cash and cash equivalents	\$ 20,974	\$ 19,487
Investment in subsidiary bank	649,545	616,108
Other assets	1,549	2,685
Total assets	\$ 672,068	\$ 638,280
Liabilities and Shareholders' Equity		
Subordinated debt, net of issuance costs	\$ 39,350	\$ 39,925
Other liabilities	262	327
Shareholders' equity	632,456	598,028
Total liabilities and shareholders' equity	\$ 672,068	\$ 638,280

Condensed Statements of Operations

	Year Ended December 31,		
	2022	2021	2020
	(Dollars in thousands)		
Dividend from subsidiary bank	\$32,000	\$32,000	\$32,000
Interest expense	(2,179)	(2,314)	(2,321)
Other expenses	(3,675)	(3,929)	(3,263)
Income before income taxes and equity in net income of subsidiary bank	26,146	25,757	26,416
Equity in undistributed net income of subsidiary bank	38,702	20,127	7,255
Income tax benefit	1,707	1,816	1,628
Net income	\$66,555	\$47,700	\$35,299

Condensed Statements of Cash Flows

	Year Ended December 31,		
	2022	2021	2020
	(Dollars in thousands)		
Cash flows from operating activities:			
Net Income	\$ 66,555	\$ 47,700	\$ 35,299
Adjustments to reconcile net income to net cash provided by operations:			
Amortization of restricted stock awards, net	2,583	1,940	1,689
Equity in undistributed net income of subsidiary bank	(38,702)	(20,127)	(7,255)
Net change in other assets and liabilities	1,222	(603)	(250)
Net cash provided by operating activities	31,658	28,910	29,483
Cash flows from financing activities:			
Proceeds from issuance of long-term debt	39,274	—	—
Repayment of long-term debt	(40,000)	—	—
Payment of cash dividends	(31,495)	(31,270)	(31,079)
Proceeds from exercise of stock options	2,050	1,469	1,714
Net cash used in financing activities	(30,171)	(29,801)	(29,365)
Net increase (decrease) in cash and cash equivalents	1,487	(891)	118
Cash and cash equivalents, beginning of year	19,487	20,378	20,260
Cash and cash equivalents, end of year	\$ 20,974	\$ 19,487	\$ 20,378

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22) Subsequent Events

On January 26, 2023, the Company announced that its Board of Directors declared a \$0.13 per share quarterly cash dividend to holders of common stock. The dividend was payable on February 23, 2023 to shareholders of record on February 9, 2023.