HERITAGE COMMERCE CORP
Form 10-K
March 14, 2019
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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

or the fiscal year ended December 31, 2018

OR

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

FOR THE TRANSITION PERIOD FROM TO

Commission file number 000 23877

Heritage Commerce Corp

(Exact name of Registrant as Specified in its Charter)

California	77 0469558
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification Number)

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

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

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

Title of Each Class	Name of Each Exchange on which Registered
Common Stock, no par value	The NASDAQ Stock Market LLC (NASDAQ Global Select Market)

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

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10 -K, or any amendment to this Form 10 -K.

Indicate by check mark whether the registrant is 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 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, 2018, based upon the closing price on that date of $16.99 per share as reported on the NASDAQ Global Select Market, and 32,404,215 shares held, was approximately $550.5 million.

As of February 28, 2019, there were 43,299,569 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 2019 Annual Meeting of Shareholders to be held on May 23, 2019 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, 2018.

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FOR YEAR ENDED DECEMBER 31, 2018

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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 “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:

- 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;
- our ability to anticipate interest rate changes and manage interest rate risk;
- changes in inflation, interest rates, and market liquidity which may impact interest margins and impact funding sources;
- volatility in credit and equity markets and its effect on the global economy;
- 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;
- risks associated with concentrations in real estate related loans;
- the relative strength or weakness of the commercial and real estate markets where our borrowers are located;
- other than temporary impairment charges to our securities portfolio;
- changes in the level of nonperforming assets and charge offs and other credit quality measures, and their impact on the adequacy of the Company’s allowance for loan losses and the Company’s provision for loan losses;
- increased capital requirements for our continued 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 if at all;
- regulatory limits on Heritage Bank of Commerce’s ability to pay dividends to the holding company;
- changes in our capital management policies, including those regarding business combinations, dividends, and share repurchases;

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- 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, and results of operations;
- the potential increase in reserves and allowance for loan loss as a result of the transition to the current expected credit loss standard ("CECL") established by the Financial Accounting Standards Board to account for future expected credit losses;
- possible impairment of our goodwill and other intangible assets;
- 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 or SBA loan programs, or changes in those programs;
- compliance with governmental and regulatory requirements, including the Dodd-Frank Act and others relating to banking, consumer protection, securities , accounting and tax matters;
- significant changes in applicable laws and regulations, including those concerning taxes, banking and securities;
- 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;
- costs and effects of legal and regulatory developments, including resolution of legal proceedings or regulatory or other governmental inquiries, and the results of regulatory examinations or reviews;
- availability and competition for acquisition opportunities;
- risks resulting from domestic terrorism;
- risks of natural disasters (including earthquakes) 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 14 full service branch offices located entirely in the southern and eastern regions of the general San Francisco Bay Area of California in the counties of Santa Clara, Alameda, Contra Costa, and San Benito. 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 Department of Business Oversight — Division of Financial Institutions (“DBO”), and by the Federal Reserve, as its primary federal regulator.

Our principal executive office is located at 150 Almaden Boulevard, San Jose, California 95113, telephone number: (408) 947-6900.

At December 31, 2018, we had consolidated assets of $3.10 billion, deposits of $2.64 billion and shareholders’ equity of $367.5 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 “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 SEC website.

Tri-Valley Bank and United American Bank Mergers

The Company completed the merger of Tri-Valley Bank ("Tri-Valley") into Heritage Bank of Commerce, the Company's wholly-owned subsidiary, on April 6, 2018. Tri-Valley's results of operations have been included in the Company's results of operations beginning April 7, 2018. Tri-Valley was a full-service California state-chartered commercial bank with branches in San Ramon and Livermore, California and served businesses and individuals primarily in Contra Costa and Alameda counties in Northern California. The Company closed the San Ramon office on July 13, 2018 and incurred $110,000 of lease termination expense.

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The Company completed the merger of United American Bank ("United American") with Heritage Bank of Commerce on May 4, 2018. United American's results of operations have been included in the Company's results of operations beginning May 5, 2018. United American was a full-service commercial bank located in San Mateo County with full-service branches located in San Mateo, Redwood City and Half Moon Bay, California and serviced businesses, professionals and individuals. The Company closed the Half Moon Bay office on August 10, 2018 and incurred $34,000 of lease termination expense.

Tri-Valley added $112.0 million in loans and $82.6 million in deposits at December 31, 2018. United American added $181.5 million in loans and $217.6 million in deposits at December 31, 2018. Severance, retention, acquisition, and integration costs related to the two mergers totaled $9.2 million for the year ended December 31, 2018, and $671,000 for the year ended December 31, 2017.

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 fourteen 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:

San Jose:	Administrative Office & Branch Office 150 Almaden Boulevard San Jose, CA 95113	Morgan Hill:	Branch Office 18625 Sutter Boulevard Suite 100 Morgan Hill, CA 95037
Danville:	Branch Office 387 Diablo Road Danville, CA 94526	Pleasanton:	Branch Office 300 Main Street Pleasanton, CA 94566
Fremont:	Branch Office 3137 Stevenson Boulevard Fremont, CA 94538	Redwood City:	Branch Office 2400 Broadway Suite 100 Redwood City, CA 94063
Gilroy:	Branch Office 7598 Monterey Street Suite 110	San Mateo:	Branch Office 101 South Ellsworth Ave

	Gilroy, CA 95020		Suite 110 San Mateo, CA 94401
Hollister:	Branch Office 351 Tres Pinos Road Suite 102A Hollister, CA 95023	Sunnyvale:	Branch Office 333 West Camino Real Suite 150 Sunnyvale, CA 94087
Livermore:	Branch Office 1987 First Street Livermore, CA 94550	Walnut Creek:	Branch Office 101 Ygnacio Valley Road Suite 100 Walnut Creek, CA 94596
Los Altos:	Branch Office 419 South San Antonio Road Los Altos, CA 94022	Bay View Funding:	Administrative Office 2933 Bunker Hill Lane Suite 210 Santa Clara, CA 95054
Los Gatos:	Branch Office 15575 Los Gatos Boulevard Suite B Los Gatos, CA 95032		

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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. 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, 2018, 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 32% (including SBA loans, asset-based lending, and factored receivables); (ii) commercial real estate loans 52%; (iii) land and construction loans 6%; (iv) residential mortgage loans 3%; and (v) consumer loans (including home equity loans) 7%. 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 is 36 days.

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. 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.

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 three categories: loans originated under the SBA's 7a Program ("7a Loans"); loans originated under the SBA's 504 Program ("504 Loans"); and SBA "Express" Loans. 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.

Residential Mortgage Loans. From time to time the Company has purchased single family residential mortgage loans. During the year ended December 31, 2016, the Company purchased jumbo single family residential mortgage loans totaling $57.5 million, all of which are domiciled in California, with an average loan principal amount of approximately $834,000, and weighted average yield of 3.00%, net of servicing fees to the servicer. There were no purchases of residential mortgage loans during the years ended December 31, 2018 and 2017. Residential mortgage loans outstanding at December 31, 2018 totaled $51.0 million, which included $37.6 million of purchased residential mortgage loans, and $13.4 million of residential mortgage loans from United American. Residential mortgage loans outstanding at December 31, 2017 totaled $44.6 million. HBC does not originate first trust deed home mortgage loans or home improvement loans, other than HELOCS.

Consumer 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.

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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. In order to facilitate 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, nor does it accept loan applications through its online services. 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 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 general investment strategies are developed and authorized by our Finance and Investment Committee of the Board of Directors. The investment policy is reviewed annually by the Finance and Investment Committee, and any changes to the policy are subject to approval by the full Board of Directors. The overall objectives of the investment policy are to maintain a portfolio of high quality investments to maximize interest income over the long term and to minimize risk, to provide collateral for borrowings, and to provide additional earnings when loan production is low. The policy dictates that investment decisions take into consideration the

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safety of principal, liquidity requirements and interest rate risk management. All securities transactions are reported to the Board of Directors' Finance and Investment Committee on a monthly basis.

Sources of Funds

Deposits traditionally have been our primary source of funds for our investment and lending activities. We also are able to borrow from the Federal Home Loan Bank of San Francisco and the Federal Reserve Bank of San Francisco to supplement cash flow needs. Our additional sources of funds are scheduled loan payments, maturing investments, loan repayments, income on other earning assets, and the proceeds of loan sales 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 26, 2017, the Company completed an underwritten public offering of $40.0 million aggregate principal amount of its fixed-to-floating rate subordinated notes ("Subordinated Debt") due June 1, 2027. The Subordinated Debt initially bears a fixed interest rate of 5.25% per year. Commencing on June 1, 2022, the interest rate on the Subordinated Debt resets quarterly to the three-month LIBOR rate plus a spread of 336.5 basis points. Interest on the Subordinated Debt is payable semi-annually on June 1st and December 1st of each year through June 1, 2022 and quarterly thereafter on March 1st, June 1st, September 1st and December 1st of each year through the maturity date or early redemption date. The Company, at its option, may redeem the Subordinated Debt, in whole or in part, on any interest payment date on or after June 1, 2022 without a premium. The Subordinated Debt, net of unamortized costs totaled $39.4 million at December 31, 2018 and $39.2 million at December 31, 2017, and qualifies as Tier 2 capital for the Company under the guidelines established by the Federal Reserve Bank. The Company down streamed $20.0 million of the proceeds to HBC during the second quarter of 2017.

Correspondent Banks

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

Competition

The banking and financial services business in California generally, and in the Company's market areas specifically, is highly competitive. The industry continues to consolidate and unregulated competitors have entered banking markets with products targeted at highly profitable customer segments. Many larger unregulated competitors are able to compete across geographic boundaries, and provide customers with meaningful alternatives to most significant banking services and products. These consolidation trends are likely to continue. The increasingly competitive environment is a result primarily of changes in regulation, changes in technology and product delivery systems, and the consolidation among financial service providers.

With respect to commercial bank competitors, the business is dominated by a relatively small number of major banks that operate a large number of offices within our geographic footprint. For the combined Santa Clara, Alameda, Contra Costa, San Mateo, and San Benito county region, the five counties within which the Company operates, the top three institutions are all multi billion dollar entities with an aggregate of 321 offices that control a combined 52.90% of deposit market share based on June 30, 2018 FDIC market share data. HBC ranks fourteenth with 0.95% share of total deposits based on June 30, 2018 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

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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."

Employees

Full-time equivalent employees were 302, 278, and 263 at December 31, 2018, 2017, and 2016, respectively.

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 DBO, the Federal Reserve, the FDIC, and the Consumer Financial Protection Bureau ("CFPB"). Furthermore, tax laws administered by the Internal Revenue Service and state taxing authorities, accounting rules developed by the FASB, securities laws administered by the SEC and state securities authorities, anti-money laundering laws enforced by the Treasury have an impact on our business. The effect of 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, and 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 may make, 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,

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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

The Dodd-Frank Act implemented sweeping reform across the U.S. financial regulatory framework, including, among other changes:

- creating a Financial Stability Oversight Council tasked with identifying and monitoring systemic risks in the financial system;
- creating the CFPB, which is responsible for implementing, examining and enforcing compliance with federal consumer financial protection laws;
- requiring the FDIC to make its capital requirements for insured depository institutions countercyclical, so that capital requirements increase in times of economic expansion and decrease in times of economic contraction;
- imposing more stringent capital requirements on bank holding companies and subjecting certain activities, including interstate mergers and acquisitions, to heightened capital conditions;
- with respect to mortgage lending:
- significantly expanding requirements applicable to loans secured by 1-4 family residential real property;
- imposing strict rules on mortgage servicing, and
- requiring the originator of a securitized loan, or the sponsor of a securitization, to retain at least 5% of the credit risk of securitized exposures unless the underlying exposures are qualified residential mortgages or meet certain underwriting standards;
- changing the assessment base for federal deposit insurance from the amount of the insured deposits held by the depository institution to the depository institution’s average total consolidated assets less tangible equity, eliminating the ceiling on the size of the FDIC’s Deposit Insurance Fund and increasing the floor of the size of the FDIC’s Deposit Insurance Fund;
- eliminating all remaining restrictions on interstate banking by authorizing state banks to establish de novo banking offices in any state that would permit a bank chartered in that state to open a banking office at that location;
- repealing the federal prohibitions on the payment of interest on demand deposits, thereby permitting depository institutions to pay interest on business transaction and other accounts; and
- in the so-called “Volcker Rule,” subject to numerous exceptions, prohibiting depository institutions and affiliates from certain investments in, and sponsorship of, hedge funds and private equity funds and from engaging in proprietary trading.

On February 3, 2017, President Trump signed an executive order calling for his administration to review existing U.S. financial laws and regulations, including the Dodd-Frank Act, in order to determine their consistency with a set of

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“core principles” of financial policy. The core financial principles identified in the executive order include the following: empowering Americans to make independent financial decisions and informed choices in the marketplace, save for retirement, and build individual wealth; preventing taxpayer-funded bailouts; fostering economic growth and vibrant financial markets through more rigorous regulatory impact analysis that addresses systemic risk and market failures, such as moral hazard and information asymmetry; enabling American companies to be competitive with foreign firms in domestic and foreign markets; advancing American interests in international financial regulatory negotiations and meetings; and restoring public accountability within Federal financial regulatory agencies and “rationalizing” the Federal financial regulatory framework.

Many aspects of the Dodd-Frank Act are subject to rulemaking and will take effect over several years, making it difficult to anticipate the overall financial impact on us. Although the reforms primarily target systemically important financial service providers, the Dodd-Frank Act’s influence has and is expected to continue to filter down in varying degrees to smaller institutions over time. We will continue to evaluate the effect of the Dodd-Frank Act; however, in many respects, the ultimate impact of the Dodd-Frank Act will not be fully known for years, and no current assurance may be given that the Dodd-Frank Act, or any other new legislative changes, will not have a negative impact on the results of operations and financial condition of the Company and HBC.

On May 24, 2018, President Trump signed the Economic Growth, Regulatory Relief and Consumer Protection Act (the “Economic Growth Act”), which repeals or modifies certain provisions of the Dodd-Frank Act and eases regulations on all but the largest banks. The Economic Growth Act also includes regulatory relief for certain institutions, whereby among other things, it simplifies capital calculations by requiring regulators to adopt a threshold for a community bank leverage ratio of between 8% to 10%, institutions under $10 billion in assets that meet such community bank leverage ratio will automatically be deemed to be well-capitalized, although regulators retain the flexibility to determine that a depository institution may not qualify for the community bank leverage ratio test based on the institution’s risk profile, and exempts community banks from Section 13 of the Bank Holding Company Act if they have less than $10 billion in total consolidated assets; and exempts banks with less than $10 billion in assets, and total trading assets and liabilities not exceeding more than five percent of their total assets, from the Volcker Rule restrictions on trading with their own capital. The Economic Growth Act also adds certain protections for consumers, including veterans and active duty military personnel, expanded credit freezes and creation of an identity theft protection database.

Other legislative and regulatory initiatives which could affect the Company, HBC and the banking industry in general may be proposed or introduced before the U.S. Congress, the California legislature and other governmental bodies in the future. In addition, the various banking regulatory agencies often adopt new rules and regulations to implement and enforce existing legislation. It cannot be predicted whether, or in what form, any such legislation or regulations may be enacted or the extent to which the business of the Company or HBC would be affected thereby.

Regulatory Capital Requirements

The federal banking agencies have risk-based capital adequacy guidelines intended to provide a measure of capital adequacy that reflects the degree of risk associated with a banking organization’s operations, both for transactions reported on the balance sheet as assets and for transactions, such as letters of credit and recourse arrangements, that are recorded as off-balance sheet items. In 2013, the Federal Reserve, FDIC, and Office of the Comptroller of the Currency issued final rules (the “Basel III Capital Rules”) establishing a new comprehensive capital framework for U.S. banking organizations. The rules implement the Basel Committee’s December 2010 framework, commonly referred to as Basel III, for strengthening international capital standards, as well as implementing certain provisions of the Dodd-Frank Act.

The Basel III Capital Rules became effective for the Company and HBC on January 1, 2015 (subject to phase-in periods for some of their components). The Basel III Capital Rules: (i) introduce a new capital measure called Common Equity Tier 1 ("CET1"), and a related regulatory capital ratio of CET1 to risk-weighted assets; (ii) specify that Tier 1 capital consists of CET1 and "Additional Tier 1 capital" instruments, which are instruments treated as Tier 1 instruments under the prior capital rules that meet certain revised requirements; (iii) mandate that most deductions or adjustments to regulatory capital measures be made to CET1 and not to the other components of capital; and (iv) expand the scope of the deductions from and adjustments to capital, as compared to existing regulations. Under the Basel III Capital Rules, for most banking organizations, the most common form of additional Tier 1 capital is noncumulative perpetual preferred stock and the most common form of Tier 2 capital is subordinated notes and a portion of the allowance for loan and lease losses, in each case, subject to the Basel III Capital Rules' specific requirements.

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Under the Basel III Capital Rules, the following are the initial minimum capital ratios applicable to the Company and HBC as of January 1, 2015:

4.0% Tier 1 leverage ratio;

4.5% CET1 to risk-weighted assets;

6.0% Tier 1 capital (that is, CET1 plus Additional Tier 1 capital) to risk-weighted assets; and

8.0% total capital (that is, Tier 1 capital plus Tier 2 capital) to risk-weighted assets.

The Basel III Capital Rules also introduced a "capital conservation buffer," composed entirely of CET1, on top of 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 CET1 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. The implementation of the capital conservation buffer began on January 1, 2016 at 0.625% and will be phased in over a three-year period (increasing by that amount on each subsequent January 1, until it reached 2.5% on January 1, 2019). In 2017, banking organizations, including the Company and HBC, were required to maintain a CET1 capital ratio of at least 5.75%, a Tier 1 capital ratio of at least 7.25%, and a total capital ratio of at least 9.25% to avoid limitations on capital distributions and certain discretionary incentive compensation payments. During 2018, banking organizations, including the Company and HBC, were required to maintain a CET1 capital ratio of at least 6.375%, a Tier 1 capital ratio of at least 7.875%, and a total capital ratio of at least 9.875% to avoid limitations on capital distributions and certain discretionary incentive compensation payments. As of January 1, 2019, the Company and HBC must maintain the following fully phased-in minimum capital ratios:

4.0% Tier 1 leverage ratio;

4.5% CET1 to risk-weighted assets, plus the capital conservation buffer, effectively resulting in a minimum ratio of CET1 to risk-weighted assets of at least 7%;

6.0% Tier 1 capital to risk-weighted assets, plus the capital conservation buffer, effectively resulting in a minimum Tier 1 capital ratio of at least 8.5%; and

8.0% total capital to risk-weighted assets, plus the capital conservation buffer, effectively resulting in a minimum total capital ratio of at least 10.5%.

The Basel III Capital Rules provide for a number of deductions from and adjustments to CET1. These include, for example, the requirement that: (i) mortgage servicing rights; (ii) deferred tax assets arising from temporary differences that could not be realized through net operating loss carrybacks; and (iii) significant investments in non-consolidated financial entities be deducted from CET1 to the extent that any one such category exceeds 10% of CET1 or all such items, in the aggregate, exceed 15% of CET1. Implementation of the deductions and other adjustments to CET1 began on January 1, 2015 and would be phased-in over a four-year period (beginning at 40% on January 1, 2015 and an additional 20% per year thereafter). Under the Basel III Capital Rules, the effects of certain accumulated other comprehensive income or loss items are not excluded for the purposes of determining regulatory capital ratios; however, non-advanced approaches banking organizations (i.e., banking organizations with less than $250 billion in total consolidated assets or with less than $10 billion of on-balance sheet foreign exposures), including the Company and HBC, may make a one-time permanent election to exclude these items. The Company and HBC made this election in the first quarter of 2015's call reports in order to avoid significant variations in the level of capital depending upon the impact of interest rate fluctuations on the fair value of its available-for-sale investment securities portfolio.

The Basel III Capital Rules prescribe a new standardized approach for risk weightings that expands the risk weighting categories from the previous four Basel I-derived categories (0%, 20%, 50% and 100%) to a larger and more risk-sensitive number of categories, generally ranging from 0% for U.S. Government and agency securities, to 600% for certain equity exposures, depending on the nature of the assets. The new capital rules generally result in higher risk weights for a variety of asset classes, including certain CRE mortgages. Additional aspects of the Basel III Capital Rules that are relevant to the Company and HBC include:

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- consistent with the Basel I risk-based capital rules, assigning exposures secured by single-family residential properties to either a 50% risk weight for first-lien mortgages that meet prudent underwriting standards or a 100% risk weight category for all other mortgages;
- providing for a 20% credit conversion factor for the unused portion of a commitment with an original maturity of one year or less that is not unconditionally cancellable (set at 0% under the Basel I risk-based capital rules);
- assigning a 150% risk weight to all exposures that are nonaccrual or 90 days or more past due (set at 100% under the Basel I risk-based capital rules), except for those secured by single-family residential properties, which will be assigned a 100% risk weight, consistent with the Basel I risk-based capital rules;
- applying a 150% risk weight instead of a 100% risk weight for certain high volatility CRE acquisition, development and construction loans; and
- applying a 250% risk weight to the portion of mortgage servicing rights and deferred tax assets arising from temporary differences that could not be realized through net operating loss carrybacks that are not deducted from CET1 capital (set at 100% under the Basel I risk-based capital rules).

As of December 31, 2018, the Company's and HBC's capital ratios exceeded the minimum capital adequacy guideline percentage requirements of the federal banking agencies for "well capitalized" institutions under the Basel III capital rules on a fully phased-in basis.

With respect to HBC, the Basel III Capital Rules also revise the prompt corrective action ("PCA"), regulations pursuant to Section 38 of the Federal Deposit Insurance Act, as discussed below under "Prompt Corrective Action."

Prompt Corrective Action

The Federal Deposit Insurance Act, as amended ("FDIA"), requires federal banking agencies to take PCA in respect of depository institutions that do not meet minimum capital requirements. The FDIA includes the following five capital tiers: "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized," and "critically undercapitalized." A depository institution's capital tier will depend upon how its capital levels compare with various relevant capital measures and certain other factors, as established by regulation. The Basel III Capital Rules, revised the PCA requirements effective January 1, 2015. Under the revised PCA provisions of the FDIA, an insured depository institution generally will be classified in the following categories based on the capital measures indicated:

PCA Category	Total Risk-Based Capital Ratio	Tier 1 Risk-Based Capital Ratio	CET1 Risk-Based Ratio	Tier 1 Leverage Ratio
Well capitalized	10 %	8.0 %	6.5 %	5.0 %
Adequately capitalized	8 %	6.0 %	4.5 %	4.0 %
Undercapitalized	< 8 %	< 6 %	< 4.5 %	< 4 %
Significantly undercapitalized	< 6 %	< 4 %	< 3.0 %	< 3 %

The institution is considered "critically undercapitalized" if the institution's tangible equity (defined as Tier 1 equity plus non-Tier 1 perpetual preferred stock) is equal to or less than 2.0% of average quarterly tangible assets.

An institution may be downgraded to, or deemed to be in, a capital category that is lower than indicated by its capital ratios, if it is determined to be in an unsafe or unsound condition or if it receives an unsatisfactory examination rating with respect to certain matters. A bank's capital category is determined solely for the purpose of applying PCA regulations and the capital category may not constitute an accurate representation of the bank’s overall financial condition or prospects for other purposes.

The FDIA generally prohibits a depository institution from making any capital distributions (including payment of a dividend) or paying any management fee to its parent holding company, if the depository institution would thereafter be “undercapitalized.” “Undercapitalized” institutions are subject to growth limitations and are required to submit capital restoration plans. If a depository institution fails to submit an acceptable plan, it is treated as if it is "significantly undercapitalized." "Significantly undercapitalized" depository institutions may be subject to a number of requirements and restrictions, including orders to sell sufficient voting stock to become "adequately capitalized," requirements to reduce total assets, and cessation of receipt of deposits from correspondent banks. "Critically undercapitalized" institutions are subject to the appointment of a receiver or conservator.

The capital classification of a bank holding company and a bank affects the frequency of regulatory examinations, the bank holding company's and the bank's ability to engage in certain activities and the deposit insurance premium paid by the bank. As of December 31, 2018, we met the requirements to be "well-capitalized" based upon the aforementioned ratios for purposes of the prompt corrective action regulations, as currently in effect.

The appropriate federal banking agency may determine (after notice and opportunity for a hearing) that the institution is in an unsafe or unsound condition or deems the institution to be engaging in an unsafe or unsound practice. The appropriate agency is also permitted to require an adequately capitalized or undercapitalized institution to comply with the supervisory provisions as if the institution were in the next lower category (but not treat a significantly undercapitalized institution as critically undercapitalized) based on supervisory information other than the capital levels of the institution.

Heritage Commerce Corp

General. As a bank holding company, HCC is subject to regulation and supervision by, the Federal Reserve under the Bank Holding Company Act of 1956, as amended, or the BHCA. Under the BHCA, HCC is subject to periodic examination by the Federal Reserve. HCC is required to file with the Federal Reserve periodic reports of the its operations and such additional information as the Federal Reserve may require. In accordance with Federal Reserve policy, and as now codified by the Dodd-Frank Act, HCC is legally obligated 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 DBO.

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, for example: (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) 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

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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 eligibility requirements prescribed by the BHCA and elect to operate as financial holding companies may engage in, or own shares in companies engaged in, a wider range of nonbanking activities, including securities and insurance underwriting and sales, merchant banking and any other activity that the Federal Reserve, in consultation with the Secretary of the Treasury, determines by regulation or order is financial in nature or incidental to any such financial activity or that the Federal Reserve determines by order to be complementary to any such financial activity and does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally. 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 the Dodd-Frank Act 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. The Dodd-Frank Act codified this policy as a statutory requirement. Under this requirement HCC is expected to commit resources to support HBC, including at times when HCC may not be in a financial position to provide it. HCC must stand ready to use its available resources to provide adequate capital to the subsidiary bank 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 or a violation of the Federal Reserve’s regulations or both. The source of strength doctrine most directly affects bank holding companies where a bank holding company’s subsidiary bank fails to maintain adequate capital levels. In such a 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 HBC are subordinate in right of payment to deposits and to certain other indebtedness of HBC. The BHCA provides that in the event of HCC’s bankruptcy any commitment by a bank holding company to a federal bank regulatory agency to maintain the capital of its subsidiary bank will be assumed by the bankruptcy 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. If HCC’s fails to adhere to these policies, the Federal Reserve could find that HCC is operating in an unsafe and unsound manner. In addition, under the Basel III Rule, institutions that seek to pay dividends must maintain 2.5% in CET1 attributable to the capital conservation buffer, which was being phased in over a three year period and is fully phased in as of January 1, 2019. See “Supervision and Regulation—Regulatory Capital Requirements” above.

Subject to exceptions for well-capitalized and well-managed holding companies, Federal Reserve regulations also require approval of 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

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distribution plus (ii) the amount, if any, of dividends in arrears on shares with preferential dividend rights. HCC may also make a distribution if, immediately after the distribution, the value of its assets equals or exceeds the sum of (a) its total liabilities plus (b) 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 or any of bank holding company's acquisition of more than 5% of a class of voting securities of any additional bank or bank holding company or to acquire all or substantially all, the assets of any additional bank or bank holding company. In reviewing applications seeking approval of merger and acquisition transactions, 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 applicant's performance record under the Community Reinvestment Act of 1977, as amended ("CRA"), the applicant's compliance with fair housing and other consumer protection laws and the effectiveness of all organizations involved 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 the Dodd-Frank Act), 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 the Dodd-Frank Act, 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.

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. "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 by any person (including a company) must be approved by the Commissioner of the DBO. 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. As a California commercial bank whose deposits are insured by the FDIC, HBC is subject to regulation, supervision, and regular examination by the DBO and by the Federal Reserve as HBC's primary Federal regulators. The regulations of these agencies govern most aspects of a bank's business.

Pursuant to 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 may a national bank, provided the bank is and remains "well capitalized," "well managed" and in satisfactory compliance with the CRA.

HBC is a member of the Federal Home Loan Bank ("FHLB") of San Francisco. Among other benefits, each FHLB serves as a reserve or central bank for its members within its assigned region and makes available loans or advances to its members. Each FHLB is financed primarily from the sale of consolidated obligations of the FHLB system. As an FHLB member HBC is required to own a certain amount of capital stock in the FHLB. At December 31, 2018, 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 Federal Reserve Bank ("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. Cash dividends received are reported as income.

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

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, 2018, 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 loan loss, and any capital notes and debentures of the bank.

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, or furnish any services, or fix or vary the consideration for any of the foregoing on the condition that: (i) the customer must obtain or provide some additional credit, property or services from or to HBC other than a loan, discount, deposit or trust services; (ii) the customer must obtain or provide some additional credit, property or service from or to HCC or HBC; or (iii) the customer must not obtain some other credit, property or services from competitors, except reasonable requirements to assure soundness of credit extended.

Deposit Insurance. As an FDIC-insured institution, HBC is required to pay deposit insurance premium assessments to the FDIC. The premiums fund the Deposit Insurance Fund ("DIF"). The FDIC assesses a quarterly deposit insurance premium on each insured institution based on risk characteristics of the institution and may also impose special assessments in emergency situations. Effective July 1, 2016, the FDIC changed the deposit insurance assessment system for banks, such as HBC, with less than $10 billion in assets that have been federally insured for at least five years. Among other changes, the FDIC eliminated risk categories for such banks and now uses the "financial ratios method" to determine assessment rates for all such banks. Under the financial ratios method, the FDIC determines assessment rates based on a combination of financial data and supervisory ratings that estimate a bank's probability of failure within three years. The assessment rate determined by considering such information is then applied to the amount of the institution's average assets minus average tangible equity to determine the institution's insurance premium.

The Dodd-Frank Act requires the FDIC to ensure that the DIF reserve ratio reaches 1.35% by September 3, 2020. The DIF reserve ratio is the amount in the DIF as a percentage of DIF-insured deposits. The Dodd-Frank Act also altered the minimum designated reserve ratio by the DIF, increasing the minimum from 1.15% to 1.35%, and eliminated the requirement that the FDIC pay dividends to depository institutions when the reserve ratio exceeds certain thresholds. At least semi-annually, the FDIC updates its loss and income projections for the DIF and, if needed, may increase or decrease the assessment rates, following notice and comment on proposed rulemaking if required. As a result, HBC's FDIC deposit insurance premiums could increase. During the year ended December 31, 2018, HBC paid $956,000 in total FDIC deposit insurance premiums.

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The FDIC may terminate deposit insurance of any insured institution if the FDIC finds that the insured institution has engaged in unsafe and unsound practices, is in an unsafe or unsound condition, or has violated any applicable law, regulation, rule, order or condition imposed by the FDIC or any other regulatory agency.

FICO Assessments. In addition to paying basic deposit insurance assessments, insured depository institutions must pay Financing Corporation assessments (“FICO Assessments”). Financing Corporation is a mixed-ownership governmental corporation chartered by the former FHLB Board pursuant to the Competitive Equality Banking Act of 1987 to function as a financing vehicle for the recapitalization of the former Federal Savings and Loan Insurance Corporation. Financing Corporation issued 30-year noncallable bonds of approximately $8.1 billion that mature in 2017 through 2019. Financing Corporation’s authority to issue bonds ended on December 12, 1991. Since 1996, federal legislation has required that all FDIC-insured depository institutions pay assessments to cover interest payments on Financing Corporation’s outstanding obligations. The FICO Assessment rate is adjusted quarterly and was approximately 0.00035% of average total assets less average tangible equity for the third quarter of 2018. During the year ended December 31, 2018, HBC paid $87,000 in aggregate FICO Assessments.

Supervisory Assessments. California-chartered banks are required to pay supervisory assessments to the DBO to fund its operations. The amount of the assessment paid by a California bank to the DBO is calculated on the basis of the institution’s total assets, including consolidated subsidiaries, as reported to the DBO. During the year ended December 31, 2018, HBC paid supervisory assessments to the DBO totaling $218,000.

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” above.

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 DBO 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 DBO, 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 DBO 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 Basel III Capitals Rules’ capital conservation buffer generally requires that must maintain over a 2.5% in CET1 attributable to the Capital Conservation Buffer, which is to be phased in over a three-year period that began on January 1, 2016. See “—Regulatory Capital Requirements” above. As described above, HBC exceeded its minimum capital requirements under applicable regulatory guidelines as of December 31, 2018.

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 promulgated thereunder. 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, and contains an aggregate limit on all such transactions with all affiliates of 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 and require, among other things, that: (i) the loans must be made on substantially the same terms, including interest rates and collateral, as prevailing at the time for comparable transactions with persons not affiliated with HCC or HBC; (ii) HBC follow credit underwriting procedures at least as stringent as those applicable to comparable transactions with persons who are not affiliated with HCC or HBC; and (iii) the loans not involve a greater-than-normal risk of non-payment or include other features not favorable to HBC. 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.

Safety and Soundness Standards/Risk Management. The federal banking agencies have adopted guidelines establishing operational and managerial standards to promote the safety and soundness of federally insured depository institutions. The guidelines set forth standards for internal controls, information systems, internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth, compensation, fees and benefits, asset quality and earnings.

In general, the safety and soundness guidelines prescribe the goals to be achieved in each area, and each institution is responsible for establishing its own procedures to achieve those goals. If an institution fails to comply with any of the standards set forth in the guidelines, the financial institution's primary federal regulator may require the institution to submit a plan for achieving and maintaining compliance. If a financial institution fails to submit an acceptable compliance plan, or fails in any material respect to implement a compliance plan that has been accepted by its primary federal regulator, the regulator is required to issue an order directing the institution to cure the deficiency. Until the deficiency cited in the regulator's order is cured, the regulator may restrict the financial institution's rate of growth, require the financial institution to increase its capital, restrict the rates the institution pays on deposits or require the institution to take any action the regulator deems appropriate under the circumstances. Noncompliance with the standards established by the safety and soundness guidelines may also constitute grounds for other enforcement action by the federal bank regulatory agencies, including cease and desist orders and civil money penalty assessments.

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

The federal banking agencies have adopted regulations which measure a bank's compliance with its CRA obligations on a performance based evaluation system. This system bases CRA ratings on an institution's actual lending service and investment performance rather than the extent to which the institution conducts needs assessments, documents community outreach or complies with other procedural requirements. The ratings range from “outstanding” to a low of “substantial noncompliance.” HBC had a CRA rating of “satisfactory” as of its most recent regulatory examination.

Anti-Money Laundering and Office of Foreign Assets Control Regulation. 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, 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.

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 and 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 financial institutions deploy too many assets to any one industry or segment. Concentration stemming from commercial real estate is one area of regulatory concern. The Commercial Real Estate Concentration Guidance provides supervisory criteria, including the following numerical indicators, to assist bank examiners in identifying banks with potentially significant commercial real estate loan concentrations that may warrant greater supervisory scrutiny: (i) commercial real estate 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 CRE Concentration Guidance does not limit banks’ levels of commercial real estate 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 commercial real estate concentrations. As of December 31, 2018, using regulatory definitions in the CRE Concentration Guidance, our CRE loans represented 242% of our total risk-based capital, as compared to 225% as of December 31, 2017. If the FDIC become concerned about our CRE loan concentrations, it could limit our ability to grow by restricting its 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 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 and deceptive acts and practices. These and other federal laws, 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, prohibit unfair, deceptive and abusive practices, restrict our ability to raise interest rates and subject us to substantial regulatory oversight. Violations of applicable consumer protection laws can result in significant potential liability from litigation brought by customers, including actual 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, action by the state and local attorneys general in each jurisdiction in which we operate and civil money penalties. Failure to comply with consumer protection requirements may also result in our failure to obtain any required bank

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regulatory approval for merger or acquisition transactions we may wish to pursue or our prohibition from engaging in such transactions even if approval is not required.

Many states and local jurisdictions have consumer protection laws analogous to those listed above. These federal, state and local laws regulate the manner in which financial institutions deal with customers when taking deposits, making loans or conducting other types of transactions. Failure to comply with these laws and regulations could give rise to regulatory sanctions, customer rescission rights, action by state and local attorneys general and civil or criminal liability.

The structure of federal consumer protection regulation applicable to all providers of consumer financial products and services changed significantly on July 21, 2011, when the CFPB commenced operations to supervise and enforce consumer protection laws. The consumer protection provisions of the Dodd-Frank Act 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 the Dodd-Frank Act, as well as the authority to identify and prohibit unfair, deceptive or abusive acts and practices. The review of products and practices to prevent such acts and practices is a continuing focus of the CFPB, and of banking regulators more broadly. The ultimate impact of this heightened scrutiny is uncertain but could result in changes to pricing, practices, products and procedures. It could also result in increased costs related to regulatory oversight, supervision and examination, additional remediation efforts and possible penalties. In addition, the Dodd-Frank Act provides the CFPB with broad supervisory, examination and enforcement authority over various consumer financial products and services, including the ability to require reimbursements and other payments to customers for alleged legal violations and to impose significant penalties, as well as injunctive relief that prohibits lenders from engaging in allegedly unlawful practices. The CFPB also has the authority to obtain cease and desist orders providing for affirmative relief or monetary penalties. The Dodd-Frank Act does not prevent states from adopting stricter consumer protection standards. State regulation of financial products and potential enforcement actions could also adversely affect our business, financial condition or results of operations. The CFPB has examination and enforcement authority over providers with more than $10 billion in assets. Banks and savings institutions with $10 billion or less in assets, like HBC, will continue to be examined by their applicable bank regulators.

Mortgage and Mortgage-Related Products. Because abuses in connection with home mortgages were a significant factor contributing to the financial crisis, many new rules issued by the CFPB and required by the Dodd-Frank Act address mortgage and mortgage-related products, their underwriting, origination, servicing and sales. The Dodd-Frank Act significantly expanded underwriting requirements applicable to loans secured by 1-4 family residential real property and augmented federal law combating predatory lending practices. In addition to numerous disclosure requirements, the Dodd-Frank Act imposed new standards for mortgage loan originations on all lenders, including banks and savings associations, in an effort to strongly encourage lenders to verify a borrower's ability to repay, while also establishing a presumption of compliance for certain "qualified mortgages."

Ability-to-Repay Requirement and Qualified Mortgage Rules. On January 10, 2013, the CFPB issued a final rule implementing the Dodd-Frank Act's ability-to-repay requirements. Under the final rule, lenders, in assessing a borrower's ability to repay a mortgage-related obligation, must consider eight underwriting factors: (i) current or reasonably expected income or assets; (ii) current employment status; (iii) monthly payment on the subject transaction; (iv) monthly payment on any simultaneous loan; (v) monthly payment for all mortgage-related obligations; (vi) current debt obligations, alimony, and child support; (vii) monthly debt-to-income ratio or residual income; and (viii) credit history. The final rule also includes guidance regarding the application of and methodology for evaluating these factors.

Further, the final rules require that qualified mortgages cannot include “no-doc” loans and loans with negative amortization, interest-only payments, balloon payments, terms in excess of 30 years, or points and fees paid by the borrower that exceed 3% of the loan amount, subject to certain exceptions. In addition, for qualified mortgages, the rules mandate that the monthly payment be calculated on the highest payment that will occur in the first five years of the loan, and require that the borrower’s total debt-to-income ratio generally may not be more than 43%. The final rules also provide that certain mortgages that satisfy the general product feature requirements for qualified mortgages and that also satisfy the underwriting requirements of Fannie Mae and Freddie Mac (while they operate under federal conservatorship or receivership), the U.S. Department of Housing and Urban Development, the Department of Veterans Affairs, the Department of Agriculture or the Rural Housing Service are also considered to be qualified mortgages. This second category of qualified mortgages will phase out as the aforementioned federal agencies issue their own rules regarding qualified mortgages, the conservatorship of Fannie Mae and Freddie Mac ends, and, in any event, will invest in January 2021.

As set forth in the Dodd-Frank Act, subprime (or higher-priced) mortgage loans are subject to the ability-to-repay requirement, and the final rules provide for a rebuttable presumption of lender compliance for those loans. The final rule also applied the ability-to-repay requirement to prime loans, while also providing a conclusive presumption of compliance (i.e., a safe harbor) for prime loans that are also qualified mortgages. Additionally, the final rule generally prohibits prepayment penalties (subject to certain exceptions) and sets forth a 3-year record retention period with respect to documenting and demonstrating the ability-to-repay requirement and other provisions.

Incentive Compensation Guidance and Proposed Restrictions

The federal bank regulatory agencies have issued comprehensive guidance intended to ensure that the incentive compensation policies do not undermine the safety and soundness of those organizations by encouraging excessive risk-taking. The incentive compensation guidance sets expectations for banking organizations concerning their incentive compensation arrangements and related risk-management, control and governance processes. The incentive compensation guidance, which covers all employees that have the ability to materially affect the risk profile of an organization, either individually or as part of a group, is based upon three primary principles: (i) balanced risk-taking incentives; (ii) compatibility with effective controls and risk management; and (iii) strong corporate governance. Any deficiencies in compensation practices that are identified may be incorporated into the organization's supervisory ratings, which can affect its ability to make acquisitions or take other actions. In addition, under the incentive compensation guidance, a banking organization's federal supervisor may initiate enforcement action if the organization's incentive compensation arrangements pose a risk to the safety and soundness of the organization.

In 2016, several federal financial agencies (including the Federal Reserve and FDIC) proposed restrictions on incentive-based compensation pursuant to Section 956 of the Dodd-Frank Act for financial institutions with $1 billion or more in total consolidated assets. For institutions with at least $1 billion but less than $50 billion in total consolidated assets, the proposal would impose principles-based restrictions that are broadly consistent with existing interagency guidance on incentive-based compensation. Such institutions would be prohibited from entering into incentive compensation arrangements that encourage inappropriate risks by the institution (i) by providing an executive officer, employee, director, or principal shareholder with excessive compensation, fees, or benefits, or (ii) that could lead to material financial loss to the institution. The comment period for these proposed regulations has closed, but a final rule has not been published. Depending upon the outcome of the rule making process, the application of this rule to us could require us to revise our compensation strategy, increase our administrative costs and adversely affect our ability to recruit and retain qualified employees.

Further, as discussed above, the Basel III Capital Rules limit discretionary bonus payments to bank executives if the institution's regulatory capital ratios fail to exceed certain thresholds. See "—Regulatory Capital Requirements" above.

The scope and content of the U.S. banking regulators' policies on executive compensation are continuing to develop and are likely to continue evolving in the near future.

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.

Impact of Monetary Policy

The monetary policy of the Federal Reserve has a significant effect on the operating results of financial or bank holding companies and their subsidiaries. Among the tools available to the Federal Reserve to affect the money supply are open market transactions in U.S. government securities, changes in the discount rate on member bank borrowings and changes in reserve requirements against member bank deposits. These means are used in varying combinations to influence

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overall growth and distribution of bank loans, investments and deposits, and their use may affect interest rates charged on loans or paid on deposits.

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 DBO also has broad enforcement powers over us, including the power to impose orders, remove officers and directors, impose fines and appoint supervisors and conservators.

ITEM 1A — RISK FACTORS

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

Risks Relating to 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. Unlike larger banks that are more geographically diversified, we provide banking services to customers primarily in the southern and eastern regions of the general San Francisco Bay Area of California. In recent years, there has been a gradual improvement in the U.S. economy as evidenced by a rebound in the housing market, lower unemployment and higher valuations in the equities markets; however, economic growth has been uneven, and opinions vary on the strength and direction of the economy. Uncertainties also have arisen regarding the potential for a reversal or renegotiation of international trade agreements, and the impact such actions and other policies may have on economic and market conditions. In addition, 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 high levels of unemployment, our growth and profitability could be constrained. Weak economic conditions are characterized by, among other indicators, deflation, 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, 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. All of these factors are generally detrimental to our business.

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 accounts;
- a decrease in the value of our investment securities and loans;
- an increase in the level of nonperforming and classified loans;

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- 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.

Fluctuations in interest rates may reduce net interest income and otherwise negatively affect our 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 earn on our assets, such as loans, typically 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 earn on our assets, such as loans, typically 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. Many factors affect interest rates, including governmental monetary policies, inflation, recession, changes in unemployment, the money supply and international disorder and instability in domestic and foreign financial markets.

Interest rate increases often result in larger payment requirements for our borrowers, which increases the potential for default. At the same time, the marketability of the underlying property may be adversely affected by any reduced demand resulting from higher interest rates. In a declining interest rate environment, there may be an increase in prepayments on loans as borrowers refinance their mortgages and other indebtedness at lower rates.

Changes in interest rates also can affect the value of loans, securities and other assets. 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 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.

Rising interest rates result in a decline in value of fixed-rate debt securities we hold in our investment securities portfolio. The unrealized losses resulting from holding these securities will be recognized in accumulated other comprehensive income (loss) and reduce total shareholders’ equity. Unrealized losses do not negatively affect our regulatory capital ratios; however, tangible common equity and the associated ratios would be reduced. If unrealized loss debt securities are sold, such realized losses will reduce our regulatory capital ratios.

If short-term interest rates decline, and assuming longer term interest rates fall faster, we could experience net interest margin compression as our interest-earning assets would continue to reprice downward while our interest-bearing liability rates could fail to decline in tandem. This would have a material adverse effect on our net interest income, financial condition, and results of operations.

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, 2018, the fair value of our securities portfolio was approximately $825.2 million. 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 other-than-temporary impairment in future periods and result in realized losses. The process for determining whether impairment is other-than-temporary 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, the financial condition of issuers of the securities and the performance of the underlying collateral, we may recognize realized and/or unrealized losses in future periods, which could have an adverse effect on our 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, such as the stock market, as 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.

Other primary sources of funds consist of cash from operations. 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 impact 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 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 results of operations and financial condition. 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.

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 loan losses, each of which could adversely affect our net income. As a result, our inability to

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successfully manage credit risk could have a material adverse effect on our business, financial condition or results of operations.

An important feature of our credit risk management system is our use of an internal credit risk rating and control system through which we identify, measure, monitor and mitigate existing and emerging credit risk of our customers. As this process involves detailed analysis of the customer or credit risk, taking into account both quantitative and qualitative factors, it is subject to human error. In exercising their judgment, our employees may not always be able to assign an accurate credit rating to a customer or credit risk, which may result in our exposure to higher credit risks than indicated by our risk rating and control system. Although our management seeks to address possible credit risk proactively, it is possible that the credit risk rating and control system will not identify credit risk in our loan portfolio and that we may fail to manage credit risk effectively.

Some of our tools and metrics for managing credit risk and other risks are based upon our use of observed historical market behavior and assumptions. We rely on quantitative models to measure risks and to estimate certain financial values. Models may be used in such processes as determining the pricing of various products, grading loans and extending credit, measuring interest rates and other market risks, predicting losses, assessing capital adequacy and calculating regulatory capital levels, as well as estimating the value of financial instruments and balance sheet items. Poorly designed or implemented models present the risk that our business decisions based on information incorporating such models will be adversely affected due to the inadequacy of that information. Moreover, our models may fail to predict future risk exposures if the information used in the model is incorrect, obsolete or not sufficiently comparable to actual events as they occur, or if our model assumptions prove incorrect. We seek to incorporate appropriate historical data in our models, but the range of market values and behaviors reflected in any period of historical data is not at all times predictive of future developments in any particular period and the period of data we incorporate into our models may turn out to be inappropriate for the future period being modeled. In such case, our ability to manage risk would be limited and our risk exposure and losses could be significantly greater than our models indicated.

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, and purchased residential mortgage loans) is a large portion of our loan portfolio. At December 31, 2018, approximately $1.28 billion, or 67% of our loan portfolio, was comprised of loans with real estate as a primary or secondary component of collateral. Included in the loans secured by real estate were $580.2 million or 45% of owner occupied loans. The real estate securing our loan portfolio is concentrated in California.

As a result, adverse developments affecting real estate values in our market areas could increase the credit risk associated with our real estate loan portfolio. 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, changes in tax laws and other governmental statutes, regulations and policies and acts of nature, such as earthquakes and 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 could result in losses that would adversely affect profitability. Such declines and losses would have a material adverse impact on our business, financial condition, and results of operations. In addition, if hazardous or toxic substances are found on properties pledged as collateral, the value of the real estate could be impaired. If we foreclose on and take title to such properties, we may be liable for remediation costs, as well as for personal injury and property damage. Environmental laws may require us to incur substantial expenses to address unknown liabilities and may materially reduce the affected property's value or limit our ability to use or sell the affected property.

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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, 2018, land and construction loans, (including land acquisition and development loans) totaled $122.4 million or 6% of our portfolio. Of these loans, 28% were comprised of owner occupied and 72% non-owner occupied construction and land loans. These loans involves 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.

The risks inherent in construction lending may affect adversely our results of operations. Such risks include, among other things, the possibility that contractors may fail to complete, or complete on a timely basis, construction of the relevant properties; substantial cost overruns in excess of original estimates and financing; market deterioration during construction; and lack of permanent take-out financing. Loans secured by such properties also involve additional risks because they have no operating history. In these construction loans, loan funds are advanced upon the security of the project under construction (which is of uncertain value prior to completion of construction) and the estimated operating cash flow to be generated by the completed project. Such properties may not be sold or leased so as to generate the cash flow anticipated by the borrower. A general decline in real estate sales and prices across the U.S. or locally in the relevant real estate market, a decline in demand for residential property, economic weakness, high rates of unemployment and reduced availability of mortgage credit are some of the factors that can adversely affect the borrowers' ability to repay their obligations to us and the value of our security interest in collateral, and thereby adversely affect our results of operations and financial results.

Supervisory guidance on commercial real estate concentrations could restrict our activities and impose financial requirements or limits on the conduct of our business.

As a part of their regulatory oversight, in 2006 federal bank regulators issued guidance titled, "Concentrations in Commercial Real Estate Lending, Sound Risk Management," which we refer to as the CRE Concentration Guidance. Additional guidance which focused on CRE lending, including an Interagency Statement titled, "Statement on Prudent Risk Management for Commercial Real Estate Lending," has been issued from time to time since 2006 and CRE lending continues to be a significant focus of federal and state bank regulators. These various guidelines and pronouncements were issued in response to the agencies' concerns that rising CRE concentrations might expose institutions to unanticipated earnings and capital volatility in the event of adverse changes in the commercial real estate market. The CRE Concentration Guidance identifies certain concentration levels that, if exceeded, will expose the institution to additional supervisory analysis with regard to the institution's CRE concentration risk. The CRE Concentration Guidance is designed to promote appropriate levels of capital and sound loan and risk management practices for institutions with a concentration of CRE loans. In general, the CRE Concentration Guidance establishes the following supervisory criteria as preliminary indications of possible CRE concentration risk: (i) the institution's total construction, land development and other land loans represent 100% or more of total risk-based capital; or (ii) total CRE loans as defined in the regulatory guidelines represent 300% or more of total risk-based capital, and the institution's CRE loan portfolio has increased by 50% or more during the prior 36-month period. Pursuant to the CRE Concentration Guidelines, loans secured by owner-occupied commercial real estate are not included for purposes of CRE Concentration calculation. As of December 31, 2018, using regulatory definitions in the CRE Concentration Guidance, our CRE loans represented 242% of our total risk-based capital, as compared to 225% as of December 31, 2017. If the FDIC became concerned about our CRE loan concentrations, they could inhibit our organic growth by restricting our ability to execute on our strategic plan.

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

In considering whether to make a loan secured by real property we generally require an appraisal of the property. However, an appraisal is only an estimate of the value of the property at the time the appraisal is conducted, and an error in fact or judgment could adversely affect the reliability of an appraisal. In addition, events occurring after the initial appraisal may cause the value of the real estate to decrease. As a result of any of these factors the value of collateral 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, 2018, commercial loans totaled $597.8 million or 32% of our loan portfolio (including SBA loans, asset-based lending, and factored receivables). Commercial loans often involve risks that are different from 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. Unlike residential property 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 loans are primarily made based on the identified cash flow of the borrower and secondarily on the collateral underlying the loans. Most often, this 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. If the cash flow from business operations is reduced, the borrower’s ability to repay the loan may be impaired. Due to the larger average size of each commercial loan, as well as collateral that is generally less readily-marketable, losses incurred on a small number of commercial loans could have a material adverse impact on our 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 results of operations and financial condition.

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. If general economic conditions negatively impact the markets in which we operate and small to medium-sized businesses are adversely affected or our borrowers are otherwise affected by adverse business developments, our business, financial condition and results of operations may be adversely affected.

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 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.

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 materially adversely affect our business, results of operations and financial condition.

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 or results of operations.

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, 2018 was $698,000. 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, 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, results of operations and profitability.

The non-guaranteed portion of SBA loans that we retain on our balance sheet as well as the guaranteed portion of SBA loans that we sell could expose us to various credit and default risks.

We originated $27.5 million of SBA loans for the year ended December 31, 2018. We sold $10.8 million for the year ended December 31, 2018 of the guaranteed portion of our SBA loans. We generally retain the non-guaranteed portions of the SBA loans that we originate. Consequently, as of December 31, 2018, we held $63.9 million of SBA loans on our balance sheet, $39.5 million of which consisted of the non-guaranteed portion of SBA loans and $2.6 million, or 4.1%, consisted of the guaranteed portion of SBA loans which we intend to sell in 2019. 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

Nonperforming assets take significant time to resolve and adversely affect our results of operations and financial condition, and could result in further losses in the future.

As of December 31, 2018, 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 $14.9 million, or 0.79% of our loan portfolio, and our nonperforming assets (which include nonperforming loans plus other real estate owned) totaled $14.9 million, or 0.48% of total assets. In addition, we had $7.6 million in accruing loans that were 30-89 days delinquent as of December 31, 2018.

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. When we take collateral in 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 would have an adverse effect on our net income and related ratios, such as return on assets and equity.

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

A significant source of risk arises from the possibility that losses could be sustained because borrowers, guarantors and related parties may fail to perform in accordance with the terms of their loans and leases. The underwriting and credit monitoring policies and procedures that we have adopted to address this risk may not prevent unexpected losses and such losses could have a material adverse effect on our business, financial condition, results of operations and cash flows. These unexpected losses may arise from a wide variety of specific or systemic factors, many of which are beyond our ability to predict, influence or control.

Like all financial institutions, we maintain an allowance for loan losses to provide for loan defaults and non-performance. This allowance, expressed as a percentage of loans, was 1.48%, at December 31, 2018. Allowance for loan losses is funded from a provision for loan losses, which is a charge to our income statement. Our provision for loan losses was $7.4 million for the year ended December 31, 2018.

Our allowance for loan losses may not be adequate to cover actual loan losses, and future provisions for loan losses could materially and adversely affect our business, financial condition, results of operations and cash flows. The allowance for loan losses reflects our estimate of the probable incurred losses in our loan portfolio at the relevant balance sheet date. Our allowance for loan losses 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 factors. The determination of an appropriate level of loan loss allowance is an inherently difficult and subjective process, requiring complex judgments, and is based on numerous assumptions. The amount of future losses is susceptible to changes in economic and other conditions, including changes in interest rates, 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. If our allowance for loan losses 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 and adverse impact on our business, financial condition, and results of operations.

We also 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 in our loan portfolio that may result in losses, but that have not yet been identified as non-performing or potential problem loans. Through established credit practices, we attempt to identify deteriorating loans and adjust the allowance for loan losses accordingly. However, because future events are uncertain and because we may not successfully identify all deteriorating loans in a timely manner, there may be loans that deteriorate in an accelerated time frame. We cannot be certain 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 loan losses is adequate to absorb losses on any existing loans that may become uncollectible, we may be required to take additional provisions for loan losses in the future to further supplement the allowance for loan losses, 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 loan losses 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. These adjustments may adversely affect our business, financial condition and results of operations.

The current expected credit loss standard established by the Financial Accounting Standards Board will require significant data requirements and changes to methodologies.

In the aftermath of the 2007-2008 financial crisis, the Financial Accounting Standards Board, or FASB, decided to review how banks estimate losses in the allowance for loan loss calculation, and it issued the final Current Expected Credit Loss, or CECL, standard on June 16, 2016. Currently, the impairment model used by financial institutions is based on incurred losses, and loans are recognized as impaired when there is no longer an assumption that future cash flows will be collected in full under the originally contracted terms. This model will be replaced by the CECL model that will become effective for HBC for the fiscal year beginning after December 15, 2019 in which financial institutions will be required to use historical information, current conditions and reasonable forecasts to estimate the expected loss over the life of the loan. The Company has established a company-wide, cross-functional governance structure, which oversees overall strategy for implementation of CECL. We are currently evaluating various loss methodologies to determine their correlation to our various loan categories historical performance. In the first quarter of 2018, we contracted with a third party vendor to provide a model and assist with assessing processes, portfolio segmentation, and model development. The transition to the CECL model will require significantly greater data requirements and changes to methodologies to accurately account for expected loss. HBC likely will be required to increase its reserves and allowance for loan loss as a result of the implementation of CECL.

On April 13, 2018, the Federal Reserve Board, FDIC, and Office of the Comptroller of the Currency issued a Notice of Proposed Rulemaking regarding the implementation of CECL methodology for allowances and related adjustments to regulatory capital rules. This proposed rule is subject to a 60-day comment period but, if implemented as proposed, the primary impact to HBC would be that it would be able to phase in over 3 years the adverse effects on regulatory capital that may result from the adoption of CECL. As stated above, HBC will be required to adopt CECL beginning in the first fiscal year beginning after December 15, 2019.

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, 2018 we had no other real estate owned ("OREO") on our books, 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 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. If we become subject to significant environmental liabilities, our business, financial condition, results of operations and cash flows may be materially and adversely affected.

Risks Related to 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 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. As of December 31, 2018, our goodwill totaled $83.8 million, compared to $45.7 million at December 31, 2017. 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, results of operations, and future prospects.

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 impact on our operations and financial condition, even if other favorable events occur.

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 would have an adverse effect on our levels of reported net income, return on average equity and return on average assets.

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

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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 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, results of operations and financial condition.

Risks Related to Our Capital

As a result of the Dodd-Frank Act and rulemaking, we are subject to more stringent capital requirements.

In July 2013, the U.S. federal banking authorities approved the implementation of the Basel III regulatory capital reforms, or Basel III, and issued rules affecting certain changes required by the Dodd-Frank Act. Basel III is applicable to all U.S. banks that are subject to minimum capital requirements as well as to bank and saving and loan holding companies, other than “small bank holding companies” (generally bank holding companies with consolidated assets of less than $3.0 billion). Basel III not only increases most of the required minimum regulatory capital ratios, it introduces a new common equity Tier 1 capital ratio and the concept of a capital conservation buffer. Basel III also expands the current definition of capital by establishing additional criteria that capital instruments must meet to be considered additional Tier 1 and Tier 2 capital. In order to be a “well-capitalized” depository institution under the new regime, an institution must maintain a common equity Tier 1 capital ratio of 6.5% or more; a Tier 1 capital ratio of 8% or more; a total capital ratio of 10% or more; and a Tier 1 leverage ratio of 5% or more. The Basel III capital rules became effective as applied to the Company and HBC on January 1, 2015 with a phase-in period that generally extends through January 1, 2019 for many of the changes.

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 our business, results of operations and financial conditions, generally.

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. In addition, the Company, on a consolidated basis, and HBC, on a stand-alone basis, must meet certain regulatory capital requirements and maintain sufficient liquidity. Regulatory capital requirements could increase from current levels, which could require us to raise additional capital or contract our operations. 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. Accordingly, we cannot assure you that we will be able to raise additional capital if needed or on terms acceptable to us. If we fail to maintain capital to meet regulatory requirements, our financial condition, liquidity and results of operations would be materially and adversely affected.

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, results of operations and growth prospects.

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. In addition, as a provider of relationship-based commercial banking services, we must attract and retain qualified banking personnel to continue to grow our business, and competition for such personnel can be intense. Our ability to effectively compete for senior executives and other qualified personnel by offering competitive compensation and benefit arrangements may be restricted by applicable banking laws and regulations as discussed in “Supervision and Regulation—Incentive Compensation Guidance and Proposed Restrictions.” 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 or results of operations. In addition, to attract and retain personnel with appropriate skills and knowledge to support our business, we may offer a variety of benefits, which could reduce our earnings or have a material adverse effect on our business, financial condition or 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 and the value of our common stock.

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 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. If our reputation is negatively affected, by the actions of our employees or otherwise, our business and, therefore, our operating results and the value of our common stock may be materially adversely affected.

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 framework also includes financial or other modeling methodologies that involve management assumptions and judgment. 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, results of operations or growth prospects could be materially and adversely affected. We may also be subject to potentially adverse regulatory consequences.

System failure or breaches of our network security could subject us to increased operating costs as well as litigation and other liabilities.

The computer systems and network infrastructure we use could be vulnerable to hardware and cyber-security issues. Our operations are dependent upon our ability to protect our computer equipment against damage from fire, power loss, telecommunications failure or a similar catastrophic event. We could also experience a breach by intentional or negligent conduct on the part of employees or other internal or external sources, including our third-party vendors. Any damage or failure that causes an interruption in our operations could have an adverse effect on our financial condition and results of operations. In addition, our operations are dependent upon our ability to protect the computer systems and network infrastructure utilized by us, including our internet banking activities, against damage from physical break-ins, cyber-security breaches and other disruptive problems caused by the internet or other users. Such computer break-ins and other disruptions would jeopardize the security of information stored in and transmitted through our computer systems and network infrastructure, which may result in significant liability, damage our reputation and inhibit the use of our internet banking services by current and potential customers.

We rely heavily on communications, information systems (both internal and provided by third-parties) and the internet to conduct our business. Our business is dependent on our ability to process and monitor large numbers of daily transactions in compliance with legal, regulatory and internal standards and specifications. In addition, a significant portion of our operations relies heavily on the secure processing, storage and transmission of personal and confidential information, such as the personal information of our customers and clients. In recent periods, several governmental agencies and large corporations, including financial service organizations and retail companies, have suffered major data breaches, in some cases exposing not only their confidential and proprietary corporate information, but also sensitive financial and other personal information of their clients or clients and their employees or other third-parties, and subjecting those agencies and corporations to potential fraudulent activity and their clients, clients and other third-parties to identity theft and fraudulent activity in their credit card and banking accounts. Therefore, security breaches and cyber-attacks can cause significant increases in operating costs, including the costs of compensating clients and customers for any resulting losses they may incur and the costs and capital expenditures required to correct the deficiencies in and strengthen the security of data processing and storage systems. These risks may increase in the future as we continue to increase mobile payments and other internet-based product offerings and expand our internal usage of web-based products and applications.

In addition to well-known risks related to fraudulent activity, which take many forms, such as check “kiting” or fraud, wire fraud, and other dishonest acts, information security breaches and cyber-security related incidents have become a material risk in the financial services industry. For example, several U.S. financial institutions have recently experienced significant distributed denial-of-service attacks, some of which involved sophisticated and targeted attacks intended to disable or degrade service, or sabotage systems. Other potential attacks have attempted to obtain unauthorized access to confidential information, steal money, or manipulate or destroy data, often through the introduction of computer viruses or malware, cyber-attacks and other means. Other threats of this type may include fraudulent or unauthorized access to data processing or data storage systems used by us or by our clients, electronic identity theft, “phishing,” account takeover, and malware or other cyber-attacks. To date, none of these type of attacks have had a material effect on our business or operations. Such security attacks can originate from a wide variety of sources, including persons who are involved with organized crime or who may be linked to terrorist organizations or hostile foreign governments. Those same parties may also attempt to fraudulently induce employees, customers or other users of our systems to disclose sensitive information in order to gain access to our data or that of our customers or clients.

We are also subject to the risk that our employees may intercept and transmit unauthorized confidential or proprietary information. An interception, misuse or mishandling of personal, confidential or proprietary information being sent to or received from a customer or third-party could result in legal liabilities, remediation costs, regulatory actions and reputational harm.

Unfortunately, it is not always possible to anticipate, detect, or recognize these threats to our systems, or to implement effective preventative measures against all breaches, whether those breaches are malicious or accidental. Cyber-security risks for banking organizations have significantly increased in recent years and have been difficult to detect before they occur because of the following, among other reasons:

- the proliferation of new technologies, and the use of the Internet and telecommunications technologies to conduct financial transactions;
- these threats arise from numerous sources, not all of which are in our control, including among others human error, fraud or malice on the part of employees or third-parties, accidental technological failure, electrical or telecommunication outages, failures of computer servers or other damage to our property or assets, natural disasters or severe weather conditions, health emergencies or pandemics, or outbreaks of hostilities or terrorist acts;
- the techniques used in cyber-attacks change frequently and may not be recognized until launched or until well after the breach has occurred;
- the increased sophistication and activities of organized crime groups, hackers, terrorist organizations, hostile foreign governments, disgruntled employees or vendors, activists and other external parties, including those involved in corporate espionage;

- the vulnerability of systems to third-parties seeking to gain access to such systems either directly or using equipment or security passwords belonging to employees, customers, third-party service providers or other users of our systems; and

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- our frequent transmission of sensitive information to, and storage of such information by, third-parties, including our vendors and regulators, and possible weaknesses that go undetected in our data systems notwithstanding the testing we conduct of those systems.

Our investments in systems and processes that are designed to detect and prevent security breaches and cyber-attacks and our conduct of periodic tests of our security systems and processes, may not succeed in anticipating or adequately protecting against or preventing all security breaches and cyber-attacks from occurring. Even the most advanced internal control environment may be vulnerable to compromise. Targeted social engineering attacks are becoming more sophisticated and are extremely difficult to prevent. Additionally, the existence of cyber-attacks or security breaches at third-parties with access to our data, such as vendors, may not be disclosed to us in a timely manner. As cyber-threats continue to evolve, we may be required to expend significant additional resources to continue to modify or enhance our protective measures or to investigate and remediate any information security vulnerabilities or incidents. We maintain a system of internal controls and insurance coverage to mitigate against operational risks, including data processing system failures and errors and customer or employee fraud. If our internal controls fail to prevent or detect an occurrence, 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.

As is the case with non-electronic fraudulent activity, cyber-attacks or other information or security breaches, whether directed at us or third-parties, may result in a material loss or have material consequences. Furthermore, the public perception that a cyber-attack on our systems has been successful, whether or not this perception is correct, may damage our reputation with customers and third-parties with whom we do business. A successful penetration or circumvention of system security could cause us negative consequences, including loss of customers and business opportunities, disruption to our operations and business, misappropriation or destruction of our confidential information and/or that of our customers, or damage to our customers' and/or third-parties' computers or systems, and could expose us to additional regulatory scrutiny and result in a violation of applicable privacy laws and other laws, litigation exposure, regulatory fines, penalties or intervention, loss of confidence in our security measures, reputational damage, reimbursement or other compensatory costs, additional compliance costs, and could adversely impact our results of operations, liquidity and financial condition.

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

We depend to a significant extent on a number of relationships with third-party service providers. Specifically, we receive core systems processing, essential web hosting and other internet systems, deposit processing and other processing services from third-party service providers. If these third-party service providers experience financial, operational, or technological difficulties or terminate their services and we are unable to replace them with other service providers, our operations could be interrupted. If an interruption were to continue for a significant period of time, our business, financial condition and results of operations could be adversely and materially affected. Even if we are able to replace our service providers, it may be at a higher cost to us, which could adversely affect our business, financial condition and results of operations.

We are subject to certain operational risks, including, but not limited to, customer or employee fraud and data processing system failures and errors.

Employee errors and employee and customer misconduct could subject us to financial losses or regulatory sanctions and seriously harm our reputation. Employee errors could also subject us to financial claims for negligence. Misconduct by our employees could include hiding unauthorized activities from us, conducting improper or unauthorized activities on behalf of our customers or using confidential information improperly. It is not always possible to prevent employee errors and misconduct, and the precautions we take to prevent and detect this activity may not be effective in all cases.

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.

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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 decisioning 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 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. Our financial condition, results of operations, financial reporting and reputation could be negatively affected if those representations are misleading, false, inaccurate or fraudulent and we rely on that materially misleading, false, inaccurate or fraudulent information.

Other Risks Related to Our Business

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 the equity markets our deposit customers may perceive alternative investment opportunities as providing superior expected returns. Technology and other changes have made it more convenient for bank customers to transfer funds into alternative investments or other deposit accounts such as online virtual banks and non-bank service providers. The current low interest rate environment could increase such transfers of deposits to higher yielding deposits or other investments. 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. The loss of these revenue streams and access to lower cost deposits as a source of funds could have a material adverse effect on our business, results of operations and financial condition.

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Increased competition in our markets may result in reduced loans, deposits and commissions and brokers' fees, as well as reduced net interest margin and profitability. Ultimately, we may not be able to compete successfully against current and future competitors. If we are unable to attract and retain banking customers and expand our sales market for such loans, then we may be unable to continue to grow our business and our financial condition and results of operations may be adversely affected.

We have a continuing 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 undergoing rapid technological changes with frequent introductions of new technology-driven products and services. In addition to better serving customers, the effective use of technology increases efficiency and enables financial institutions to reduce costs. Our future success will depend in part upon our ability to address the needs of our customers by using technology to provide products and services that will satisfy customer demands for convenience as well as to create additional efficiencies in our operations as we continue to grow and expand our market area. We may experience operational challenges as we implement these new technology enhancements, or seek to implement them across all of our offices and business units, which could result in us not fully realizing the anticipated benefits from such new technology or require us to incur significant costs to remedy any such challenges in a timely manner.

Many of our larger competitors have substantially greater resources to invest in technological improvements. 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. Accordingly, a risk exists that we will not be able to effectively implement new technology-driven products and services or be successful in marketing such products and services to our customers.

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

We may 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. Our insurance may not cover all claims that may be asserted against us and indemnification rights to which we are entitled may not be honored, and any claims asserted against us, regardless of merit or eventual outcome, may harm our reputation. Should the ultimate judgments or settlements in any litigation or investigation significantly exceed our insurance coverage, they could have a material adverse effect on our business, financial condition and results of operations. In addition, premiums for insurance covering the financial and banking sectors are rising. We may not be able to obtain appropriate types or levels of insurance in the future, nor may we be able to obtain adequate replacement policies with acceptable terms or at historic rates, if at all.

We currently hold a significant amount of company-owned life insurance.

At December 31, 2018, we held company-owned life insurance ("COLI") on current and former senior employees and executives, with a cash surrender value of $61.9 million, as compared with a cash surrender value of $60.8 million at December 31, 2017. The eventual repayment of the cash surrender value is subject to the ability of the various insurance companies to pay death benefits or to return the cash surrender value to us if needed for liquidity purposes. We continually monitor the financial strength of the various companies with whom we carry these policies. However, any one of these companies could experience a decline in financial strength, which could impair its ability to pay benefits or return our cash surrender value. If we need to liquidate these policies for liquidity purposes, we would be subject to taxation on the increase in cash surrender value and penalties for early termination, both of which would materially adversely impact earnings.

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.

Reputation risk is the risk to liquidity, earnings and capital arising from negative publicity regarding us or the financial services industry generally. The financial services industry was featured in negative headlines about the global and national credit crisis which commenced in 2007 and the resulting stabilization legislation enacted by the U.S. federal government. These reports, and subsequent negative press regarding systemic fee-churning problems at other institutions, continue to be damaging to the industry’s image and potentially erode confidence in insured financial institutions, such as our banking subsidiary.

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In addition, 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, results of operations and growth prospects. Additionally, if our competitors were extending credit on terms we found to pose excessive risks, or at interest rates which we believed did not warrant the credit exposure, we may not be able to maintain our business volume and could experience deteriorating financial performances.

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

Severe weather, natural disasters (including fires and earthquakes), acts of war or terrorism and other adverse external events could have a significant impact on our ability to conduct business. Such events could affect the stability of our deposit base, impair the ability of borrowers to repay outstanding loans, impair the value of collateral securing loans, cause significant property damage, result in loss of revenue and/or cause us to incur additional expenses. For example, our primary market areas in California are subject to earthquakes, fires, and droughts. 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. While we have not experienced such events to date, other severe weather or natural disasters, acts of war or terrorism or other adverse external events may occur in the future. Although management has established disaster recovery policies and procedures, the occurrence of any such events could have a material adverse effect on our business financial condition and results of operations.

Finance and Accounting Risks

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 loan losses 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.

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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 Sections 302 and 404 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 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 DBO or other regulatory authorities, which could require additional financial and management resources. These events could have an adverse effect on our business, financial condition and results of operations.

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, 2018, we had a net deferred tax assets of $27.1 million. If we were to determine at some point in the future that we will not achieve sufficient future taxable income to realize our net deferred tax asset, we would be required, under generally accepted accounting principles, to establish a full or partial valuation allowance which would require us to incur a charge to operations for the period in which the determination was made.

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 DBO 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 may add 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.

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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.

We are subject to extensive regulation by multiple regulatory bodies. These regulations may affect the manner and terms of delivery of our services. If we do not comply with governmental regulations, we may be subject to fines, penalties, lawsuits or material restrictions on our businesses in the jurisdiction where the violation occurred, which may adversely affect our business operations. Changes in these regulations can significantly affect the services that we provide as well as our costs of compliance with such regulations. 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.

Current and recent-past economic conditions, particularly in the financial markets, have resulted in government regulatory agencies and political bodies placing increased focus and scrutiny on the financial services industry. The Dodd-Frank Act significantly changed the regulation of financial institutions and the financial services industry. The Dodd-Frank Act and the regulations thereunder affect large and small financial institutions, including several provisions that will affect how community banks, thrifts and small bank and thrift holding companies will be regulated in the future.

The Dodd-Frank Act, among other things, imposed new capital requirements on bank holding companies; changed the base for FDIC insurance assessments to a bank's average consolidated total assets minus average tangible equity, rather than upon its deposit base; and permanently raised the current standard deposit insurance limit to $250,000 and expanded the FDIC's authority to raise insurance premiums. The Dodd-Frank Act established the Consumer Financial Protection Bureau (the "CFPB") as an independent entity within the Federal Reserve, which has broad rulemaking, supervisory and enforcement authority over consumer financial products and services, including deposit products, home mortgages, home-equity loans and credit cards, and contains provisions on mortgage-related matters, such as steering incentives, determinations as to a borrower's ability to repay and prepayment penalties. Although the applicability of certain elements of the Dodd-Frank Act is limited to institutions with more than $10 billion in assets, there can be no guarantee that such applicability will not be extended in the future or that regulators or other third parties will not seek to impose such requirements on institutions with less than $10 billion in assets, such as HBC. Compliance with the Dodd-Frank Act and its implementing regulations has and will continue to result in additional operating and compliance costs that could have a material adverse effect on our business, financial condition, results of operations and growth prospects.

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.

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.

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. The effects of such policies upon our business, financial condition and results of operations cannot be predicted.

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

The Federal Reserve, the FDIC, and the DBO 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, results of operations and growth prospects.

The Federal Reserve may require us to commit capital resources to support HBC.
As a matter of policy, the Federal Reserve expects a bank holding company to act as a source of financial and managerial strength to a subsidiary bank and to commit resources to support such subsidiary bank. The Dodd-Frank Act codified the Federal Reserve’s policy on serving as a source of financial strength. Under the “source of strength” doctrine, the Federal Reserve may require a bank holding company to make capital injections into a troubled subsidiary bank and may charge the bank holding company with engaging in unsafe and unsound practices for failure to commit resources to a subsidiary bank. A capital injection may be required at times when the bank holding

company may not have the resources to provide it and therefore may be required to borrow the funds or raise capital. Any loans by a bank holding company to its subsidiary banks are subordinate in right of payment to deposits and to certain other indebtedness of such subsidiary bank. In the event of a bank holding company’s bankruptcy, the bankruptcy trustee will assume any commitment by the bank holding company to a federal bank regulatory agency to maintain the capital of a subsidiary bank. Moreover, bankruptcy law provides that claims based on any such commitment will be entitled to a priority of payment over the claims of the institution’s general unsecured creditors, including the holders of its note obligations. Thus, any borrowing that must be incurred by us to make a required capital injection to HBC becomes more difficult and expensive and could have an adverse effect on our business, financial condition and results of operations.

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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 prohibit discriminatory lending practices by financial institutions. The U.S. Department of Justice, federal banking agencies, and other federal agencies are responsible for enforcing these laws and regulations. A challenge to an institution's compliance with fair lending laws and regulations could result in a wide variety of sanctions, including damages and civil money penalties, injunctive relief, restrictions on mergers and acquisitions activity, restrictions on expansion, and restrictions on entering new business lines. Private parties may also challenge an institution's performance under fair lending laws in private class action litigation. Such actions could have a material adverse effect on our business, financial condition, results of operations and growth prospects.

We may be subject to liability for potential violations of predatory lending laws, which could adversely impact our results of operations, financial condition and business.

Various U.S. federal, state and local laws have been enacted that are designed to discourage predatory lending practices. The U.S. Home Ownership and Equity Protection Act of 1994 ("HOEPA") prohibits inclusion of certain provisions in mortgages that have interest rates or origination costs in excess of prescribed levels and requires that borrowers be given certain disclosures prior to origination. Some states have enacted, or may enact, similar laws or regulations, which in some cases impose restrictions and requirements greater than those in HOEPA. In addition, under the anti-predatory lending laws of some states, the origination of certain mortgages, including loans that are not classified as "high-cost" loans under applicable law, must satisfy a net tangible benefit test with respect to the related borrower. Such tests may be highly subjective and open to interpretation. As a result, a court may determine that a home mortgage, for example, does not meet the test even if the related originator reasonably believed that the test was satisfied. If any of our mortgages are found to have been originated in violation of predatory or abusive lending laws, we could incur losses, which could adversely impact our results of operations, financial condition and business.

In addition, federal, state and local laws have been adopted that are intended to eliminate certain lending practices considered "predatory." These laws prohibit practices such as steering borrowers away from more affordable products, selling unnecessary insurance to borrowers, repeatedly refinancing loans and making loans without a reasonable expectation that the borrowers will be able to repay the loans irrespective of the value of the underlying property. It is our policy not to make predatory loans, but these laws create the potential for liability with respect to our lending and loan investment activities. They increase our cost of doing business and, ultimately, may prevent us from making certain loans and cause us to reduce the average percentage rate or the points and fees on loans that we do make.

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

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 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, and some of our current or planned business activities. This could also increase our costs of compliance and business operations and could reduce income from certain business initiatives. This includes increased privacy-related enforcement activity at the federal level, by the Federal Trade Commission, as well as at the state level, such as with regard to mobile applications.

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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 conditions or 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 or results of operations.

Potential limitations on incentive compensation contained in proposed federal agency rulemaking may adversely affect our ability to attract and retain our highest performing employees.

During the second quarter of 2016, the Federal Reserve and the FDIC, along with other U.S. regulatory agencies, jointly published proposed rules designed to implement provisions of the Dodd-Frank Act prohibiting incentive compensation arrangements that would encourage inappropriate risk taking at covered financial institutions, which includes a bank or bank holding company with $1 billion or more in assets. It cannot be determined at this time whether or when a final rule will be adopted and whether compliance with such a final rule will substantially affect the manner in which we structure compensation for our executives and other employees. Depending on the nature and application of the final rules, we may not be able to compete successfully with certain financial institutions and other companies that are not subject to some or all of the rules to retain and attract executives and other high performing employees. If this were to occur, relationships that we have established with our customers may be impaired and our business, financial condition and results of operations could be materially adversely affected.

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:

- actual or anticipated quarterly fluctuations in our operating results and financial condition;
- changes in business and economic 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;

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- 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 generally 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.

We are 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 or results of operations could be materially and adversely impacted.

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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.

The Basel III 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 HCC'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 HBC 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 60 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 and preferred stock, if any, 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 and preferred stock, if any, 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, 2018, we had $40.0 million principal amount of subordinated notes outstanding due June 1, 2027. 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 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 DBO 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 HCC and HBC are located at 150 Almaden Boulevard in San Jose, California 95113, with branch offices located at 15575 Los Gatos Boulevard in Los Gatos, California 95032, at 3137 Stevenson Boulevard in Fremont, California 94538, at 387 Diablo Road in Danville, California 94526, at 300 Main Street in Pleasanton, California 94566, at 101 Ygnacio Valley Road 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 101 S. Ellsworth Avenue in

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San Mateo, California 94401, and at 2400 Broadway in Redwood City, California 94063. Bay View Funding's administrative offices are located at 2933 Bunker Hill Lane, Santa Clara, CA 95054.

Main Offices

The main office of HBC is located at 150 Almaden Boulevard in San Jose, California on the first three floors in a fifteen story Class A type office building. All three floors, consisting of approximately 35,547 square feet, are subject to a direct lease dated April 13, 2000, as amended, which expires on May 31, 2020. The current monthly rent payment is $114,461, subject to annual increases of 3% until the lease expires. The Company has reserved the right to extend the term of the lease for one additional period of five years.

In November of 2014, the Company extended its lease for approximately 1,255 square feet (referred to as the "Kiosk") located next to the primary operating area at 150 Almaden Boulevard in San Jose, California to be used for meetings, staff training and marketing events. The current monthly rent payment is $4,041, subject to annual increases of 3% until the lease expires on May 31, 2020. The Company has reserved the right to extend the term of the lease for one additional period of five years.

In June of 2015, the Company amended its primary lease at 150 Almaden Boulevard in San Jose, California to include 4,484 square feet of expansion space in a five story Class B type office building located at 100 W. San Fernando Street in San Jose, California, adjacent to the main office. The current monthly rent payment is $11,748, subject to annual increases of 3% until the lease expires on May 31, 2020. 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 September of 2012, the Company leased approximately 3,172 square feet in a one-story multi tenant multi use building located at 3137 Stevenson Boulevard in Fremont, California. The monthly rent payment is $8,143 until the lease expires on February 29, 2020. The Company has reserved the right to extend the term of the lease for one additional period of four years and another additional period of three years.

In April of 2014, the Company leased 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 $4,771 until the lease expires on June 30, 2019. The Company plans on exercising its right to extend the term of the lease for one additional period of five years.

In May of 2014, the Company extended its lease for approximately 3,850 square feet on the first floor in a four-story multi tenant office building located at 101 Ygnacio Valley Road in Walnut Creek, California. The current monthly rent payment is $15,166, subject to annual increases of 3% until the lease expires on August 15, 2021. In addition, the Company modified its lease to include 1,461 square feet of expansion space. The current monthly rent for the expansion space is $4,690, subject to annual increases of 3% until the lease expires. The Company has reserved the right to extend the term of the lease for one additional period of five years.

In August of 2014, the Company amended and 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 $6,381, subject to annual increases of 2% until the lease expires on October 31, 2021. The Company has reserved the right to extend the term of the lease for one additional period of five years.

In September of 2016, 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 $5,586 until the lease expires on September 30, 2019. The Company has reserved the right to extend the term of the lease for one additional period of two years.

In July of 2017, 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

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payment is $28,403, subject to annual increases of 3% until the lease expires on April 30, 2023. The Company has reserved the right to extend the term of the lease for one additional period of five years.

In October of 2017, the Company extended 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 $20,480 until 90 days after the landlord delivers possession of a new premises, to be built adjacent to the existing premises, consisting of approximately 4,800 square feet and subject to a new lease dated November 30, 2017. The beginning monthly rent payment for the new premises will be $21,600, subject to 3% annual increases until the lease expires ten years after the date on which it becomes effective. If the landlord in unable to obtain the necessary permits and approvals from the City of Pleasanton for construction of the new premises by April 30, 2019, then a new seven-year lease for the existing premises will become effective as of May 1, 2019, with an initial monthly rent payment of $20,480, subject to annual increases of 3% until the lease expires on April 30, 2026.

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 $16,707, subject to annual increases of 3% until the lease expires on May 31, 2023.

In April of 2018, as part of the acquisition of Tri-Valley Bank, the Company assumed a 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 $8,901 until the lease expires on September 30, 2019. The Company has reserved the right to extend the term of the lease for two additional periods of five years each.

In May of 2018, as part of the acquisition of United American Bank, the Company assumed a lease for approximately 11,566 square feet on the first and second floors in a five-story multi-tenant office building located at 101 S. Ellsworth Avenue in San Mateo, California. The current monthly rent payment is $40,213, subject to annual increases of 3% until the lease expires on December 31, 2020. The Company has reserved the right to extend the lease for one additional period of five years.

In May of 2018, also as part of the acquisition of United American Bank, the Company assumed a 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 $12,437, subject to annual increases of 5% until the lease expires on October 31, 2022. The Company has reserved the right to extend the lease for one additional period of two years.

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 $6,720, 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.

Bay View Funding Office

In July of 2016, Bay View Funding extended its lease for approximately 7,440 square feet in a two story multi tenant office building located at 2933 Bunker Hill Lane, Santa Clara, CA 95054. The current monthly rent payment is $26,836 until the lease expires on February 29, 2020. The Company has reserved the right to extend the term of the lease for one additional period of five years.

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

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

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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 information in the following table for 2018 and 2017 indicates the high and low closing prices for the common stock, based upon information provided by the NASDAQ Global Select Market and cash dividend payment for each quarter presented.

	Stock Price		Dividend
Quarter	High	Low	Per Share
Year ended December 31, 2018:			
Fourth quarter	$ 15.63	$ 11.01	$ 0.11
Third quarter	$ 17.41	$ 14.71	$ 0.11
Second quarter	$ 18.05	$ 16.21	$ 0.11
First quarter	$ 17.13	$ 15.27	$ 0.11
Year ended December 31, 2017:			
Fourth quarter	$ 16.35	$ 14.28	$ 0.10
Third quarter	$ 14.23	$ 12.92	$ 0.10
Second quarter	$ 14.78	$ 13.02	$ 0.10
First quarter	$ 14.48	$ 13.20	$ 0.10

The closing price of our common stock on February 28, 2019 was $13.97 per share as reported by the NASDAQ Global Select Market.

As of February 28, 2019, 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.

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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 or Commerce – Dividend Payments."

Securities Authorized for Issuance Under Equity Compensation Plans

The following table provides information as of December 31, 2018 regarding equity compensation plans under which equity securities of the Company were authorized for issuance:

	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	1,570,603 (1)	$ 10.76	1,163,506 (2)
Equity compensation plans not approved by security holders	N/A	N/A	N/A

(1)Consists of 381,659 options to acquire shares under the Company's Amended and Restated 2004 Equity Plan and 1,188,944 options to acquire shares under the Company's 2013 Equity Incentive Plan.

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

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Performance Graph

The following graph compares the stock performance of the Company from December 31, 2013 to December 31, 2018, 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.

The following chart compares the stock performance of the Company from December 31, 2013 to December 31, 2018, to the performance of several specific industry indices. The performance of the S&P 500 Index, NASDAQ Stock Index and NASDAQ Bank Stocks were used as comparisons to the Company's stock performance.

	Period Ending					
Index	12/31/13	12/31/14	12/31/15	12/31/16	12/31/17	12/31/18
Heritage Commerce Corp *	100	107	145	175	186	138
S&P 500 *	100	111	111	121	145	136
NASDAQ - Total US*	100	113	120	129	165	159
NASDAQ Bank Index*	100	103	110	148	153	126

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

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ITEM 6 — SELECTED FINANCIAL DATA

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

SELECTED FINANCIAL DATA

	AT OR FOR YEAR ENDED DECEMBER 31,				
	2018	2017	2016	2015	2014
	(Dollars in thousands, except per share data)				
INCOME STATEMENT DATA:					
Interest income	$ 129,845	$ 106,911	$ 94,431	$ 78,743	$ 59,256
Interest expense	7,822	5,387	3,211	2,422	2,153
Net interest income before provision for loan losses	122,023	101,524	91,220	76,321	57,103
Provision (credit) for loan losses	7,421	99	1,237	32	(338)
Net interest income after provision for loan losses	114,602	101,425	89,983	76,289	57,441
Noninterest income	9,574	9,612	11,625	8,985	7,746
Noninterest expense	75,521	60,738	57,639	58,673	44,222
Income before income taxes	48,655	50,299	43,969	26,601	20,965
Income tax expense	13,324	26,471	16,588	10,104	7,538
Net income	35,331	23,828	27,381	16,497	13,427
Dividends and discount accretion on preferred stock	—	—	(1,512)	(1,792)	(1,008)
Net income available to common shareholders	35,331	23,828	25,869	14,705	12,419
Less: undistributed earnings allocated to Series C Preferred Stock	—	—	(1,278)	(912)	(1,342)
Distributed and undistributed earnings allocated to common shareholders	$ 35,331	$ 23,828	$ 24,591	$ 13,793	$ 11,077

PER COMMON SHARE DATA:					
Basic net income(1)	$ 0.85	$ 0.63	$ 0.72	$ 0.48	$ 0.42
Diluted net income(2)	$ 0.84	$ 0.62	$ 0.72	$ 0.48	$ 0.42
Book value per common share(3)	$ 8.49	$ 7.10	$ 6.85	$ 7.03	$ 6.22
Tangible book value per common share(4)	$ 6.28	$ 5.76	$ 5.46	$ 5.35	$ 5.60
Pro forma book value per common share assuming Series C Preferred Stock was converted into common stock(5)	$ —	$ —	$ —	$ 6.51	$ 5.74
Pro forma tangible book value per share, assuming Series C Preferred Stock was converted into common stock(6)	$ —	$ —	$ —	$ 5.07	$ 5.23
Dividend payout ratio(7)	52.26 %	63.95 %	49.77 %	65.09 %	42.88 %
Weighted average number of shares outstanding — basic	41,469,211	38,095,250	33,933,806	28,567,213	26,390,615
Weighted average number of shares outstanding — diluted	42,182,939	38,610,815	34,219,121	28,786,078	26,526,282
Common shares outstanding at period end	43,288,750	38,200,883	37,941,007	32,113,479	26,503,505
Pro forma common shares outstanding at period end, assuming Series C Preferred Stock was converted into common stock(8)	—	—	—	37,714,479	32,104,505
BALANCE SHEET DATA:					
Securities (available-for sale and held-to-maturity)	$ 836,241	$ 790,193	$ 630,599	$ 494,390	$ 301,697
Net loans	$ 1,858,557	$ 1,563,009	$ 1,483,518	$ 1,339,790	$ 1,070,264
	$ 27,848	$ 19,658	$ 19,089	$ 18,926	$ 18,379

Allowance for loan losses					
Goodwill and other intangible assets	$ 95,760	$ 51,253	$ 52,614	$ 54,182	$ 16,320
Total assets	$ 3,096,562	$ 2,843,452	$ 2,570,880	$ 2,361,579	$ 1,617,103
Total deposits	$ 2,637,532	$ 2,482,989	$ 2,262,140	$ 2,062,775	$ 1,388,386
Subordinated debt, net of issuance costs	$ 39,369	$ 39,183	$ —	$ —	$ —
Short-term borrowings	$ —	$ —	$ —	$ 3,000	$ —
Total shareholders' equity	$ 367,466	$ 353,566	$ 259,850	$ 245,436	$ 184,358
SELECTED PERFORMANCE RATIOS:(9)					
Return on average assets	1.16 %	0.86 %	1.13 %	0.86 %	0.88 %
Return on average tangible assets	1.19 %	0.88 %	1.15 %	0.88 %	0.88 %
Return on average equity	10.79 %	8.86 %	10.71 %	8.04 %	7.44 %
Return on average tangible equity	14.41 %	10.98 %	13.55 %	9.41 %	7.60 %
Net interest margin (fully tax equivalent)	4.31 %	3.99 %	4.12 %	4.41 %	4.10 %
Efficiency ratio (10)	57.39 %	54.65 %	56.04 %	68.78 %	68.19 %
Average net loans (excludes loans held-for-sale) as a percentage of average deposits	67.35 %	62.65 %	66.25 %	70.82 %	74.54 %
Average total shareholders' equity as a percentage of average total assets	10.72 %	9.76 %	10.54 %	10.73 %	11.85 %
SELECTED ASSET QUALITY DATA:(11)					
Net charge-offs (recoveries) to average loans	(0.04) %	(0.03) %	0.08 %	(0.04) %	0.05 %
Allowance for loan losses to total loans	1.48 %	1.24 %	1.27 %	1.39 %	1.69 %
Nonperforming loans to total loans	0.79 %	0.16 %	0.20 %	0.47 %	0.54 %
Nonperforming assets	$ 14,887	$ 2,485	$ 3,288	$ 6,742	$ 6,551

HERITAGE COMMERCE CORP CAPITAL RATIOS:										
Total risk-based	15.0	%	14.4	%	12.5	%	12.5	%	13.9	%
Tier 1 risk-based	12.0	%	11.4	%	11.5	%	11.4	%	12.6	%
Common equity Tier 1 risk-based capital	12.0	%	11.4	%	11.5	%	10.4	%	N/A	
Leverage	8.9	%	8.0	%	8.5	%	8.6	%	10.6	%

Notes:

(1)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 17 to the consolidated financial statements.

(2)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.

(3)Represents shareholders' equity minus preferred stock divided by the number of shares of common stock outstanding at December 31, 2015 and 2014.

(4)Represents shareholders' equity minus preferred stock, minus goodwill and other intangible assets divided by the number of shares of common stock outstanding at December 31, 2015 and 2014.

(5)Represents shareholders' equity minus preferred stock divided by the number of shares of common stock outstanding at December 31, 2015 and 2014, assuming 21,004 shares of Series C Preferred Stock were converted into 5,601,000 shares of common stock.

(6)Represents shareholders' equity minus preferred stock, minus goodwill and other intangible assets divided by the number of shares of common stock outstanding at December 31, 2015 and 2014, assuming 21,004 shares of Series C Preferred Stock were converted into 5,601,000 shares of common stock.

(7)Percentage is calculated based on dividends paid on common stock and Series C Preferred Stock for the year ended December 31, 2016, 2015, and 2014 (on an as converted basis) divided by net income.

(8)Assumes 21,004 shares of Series C Preferred Stock were converted into 5,601,000 shares of common stock at December 31, 2015 and 2014.

(9)Average balances used in this table and throughout this Annual Report are based on daily averages.

(10) The efficiency ratio is calculated by dividing noninterest expenses by the sum of net interest income before provision for loan losses and noninterest income.

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

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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 Co and its subsidiaries.

The Company completed its acquisition of Tri-Valley Bank ("Tri-Valley") on April 6, 2018, and the Company completed its acquisition of United American Bank ("United American") on May 4, 2018. These acquisitions are discussed in more detail below, and in Notes 1, 8, and 9 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.

We have identified the following accounting policies and estimates that, due to the inherent judgments and assumptions and the potential sensitivity of the financial statements to those judgments and assumptions, are critical to an understanding of our financial statements. We believe that the judgments, estimates and assumptions used in the preparation of the Company's financial statements are appropriate. For a further description of our accounting policies, see Note 1 — Summary of Significant Accounting Policies in the financial statements included in this Form 10 K.

Allowance for Loan Losses

The allowance for loan losses is an estimate of the losses in our loan portfolio. The allowance is only an estimate of the inherent loss in the loan portfolio and may not represent actual losses realized over time, either of losses in excess of the allowance or of losses less than the allowance. Our accounting for estimated loan losses is discussed under the heading "Allowance for Loan Losses" and disclosed primarily in Notes 1 and 4 to the consolidated financial statements.

Deferred Tax Assets

Our net deferred income tax asset arises from temporary differences between the carrying amount of assets and liabilities reported in the financial statements and the amounts used for income tax return purposes. Our accounting for deferred tax assets is discussed under the heading "Income Tax Expense" and disclosed primarily in Notes 1 and 12 to the consolidated financial statements.

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 southern and eastern regions of the general San Francisco Bay Area of California in the counties of Santa Clara, Alameda, Contra Costa, San Benito, and San Mateo. The largest city in this area is San Jose and the Company's market includes the

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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, 2018, net income was $35.3 million, or $0.84 per average diluted common share, compared to $23.8 million, or $0.62 per average diluted common share, for the year ended December 31, 2017, and $27.4 million or $0.72 per average diluted common share for the year ended December 31, 2016. The Company's annualized return on average tangible assets was 1.19% and annualized return on average tangible equity was 14.41% for the year ended December 31, 2018, compared to 0.88% and 10.98%, respectively, for the year ended December 31, 2017, and 1.15% and 13.55%, respectively, for the year ended December 31, 2016.

The Company acquired Tri-Valley and United American in the second quarter of 2018. Severance, retention, acquisition, and integration costs related to the two mergers totaled $9.2 million, for the year ended December 31, 2018, compared to $671,000 for the year ended December 31, 2017. We do not expect any further significant related cost going forward. Earnings for the year ended December 31, 2017 were also impacted by a $7.1 million income tax expense adjustment due to the remeasurement of the Company's net deferred tax assets ("DTA").

Tri-Valley Bank and United American Bank Mergers

The Company completed the merger of its wholly-owned bank subsidiary Heritage Bank of Commerce with Tri-Valley effective as of the close on April 6, 2018. Tri-Valley's results of operations have been included in the Company's results of operations beginning April 7, 2018. Tri-Valley was a full-service California state-chartered commercial bank with branches in San Ramon and Livermore, California and served businesses and individuals primarily in Contra Costa and Alameda counties in Northern California. The Company closed the San Ramon office on July 13, 2018 and incurred $110,000 of lease termination expense.

The Company completed the merger of its wholly-owned bank subsidiary Heritage Bank of Commerce with United American effective as of the close on May 4, 2018. United American's results of operations have been included in the Company's results of operations beginning May 5, 2018.

United American was a full-service commercial bank located in San Mateo County with full-service branches located in San Mateo, Redwood City and Half Moon Bay, California and serviced businesses, professionals and individuals. The Company closed the Half Moon Bay office on August 10, 2018 and incurred $34,000 of lease termination expense.

Tri-Valley added $112.0 million in loans and $82.6 million in deposits, at December 31, 2018. United American added $181.5 million in loans and $217.6 million in deposits at December 31, 2018.

Tax Cuts and Jobs Act

The Tax Cuts and Jobs Act (the "Tax Act") was signed into law on December 22, 2017, which among other things reduced the federal corporate tax rate to 21% from 35%, effective January 1, 2018. The enactment of the Tax Act caused our net DTA to be revalued at the new lower tax rate with resulting tax effects accounted for in the fourth quarter of 2017. The Company performed an analysis and determined the value of the net DTA was reduced by $7.1 million, which was recognized as a one-time, non-cash, incremental income tax expense for the fourth quarter of 2017 and for the year ended December 31, 2017.

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Factoring Activities - Bay View Funding

	December 31, 2018	December 31, 2017
	(Dollars in thousands)	
Total factored receivables	$ 53,590	$ 48,826
Average factored receivables for the year ended	$ 59,220	$ 45,794
Total full time equivalent employees	38	36

2018 Highlights

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

· Net interest income before provision for loan losses increased 20% to $122.0 million for the year ended December 31, 2018, compared to $101.5 million for the year ended December 31, 2017, primarily due to the impact of the increase in loans and deposits from the Tri-Valley and United American acquisitions, in addition to organic loan growth and the positive impact of rising interest rates.

· The fully tax equivalent ("FTE") net interest margin increased 32 basis points to 4.31% for the year ended December 31, 2018, compared to 3.99% for the year ended December 31, 2017. The increase was primarily due to a higher average balance of loans and securities, an increase in the accretion of the loan purchase discount into loan interest income from the Tri-Valley and United American acquisitions in the second quarter of 2018, the impact of increases in the prime rate, and the rate on overnight funds.

· The average yield on the loan portfolio increased to 5.87% for the year ended December 31, 2018, compared to 5.64% for the year ended December 31, 2017, primarily due to an increase in accretion of the loan purchase discount into loan interest income from the acquisitions, and increases in the prime rate. The average yield on the Company's legacy loan portfolio (excluding the purchased residential loans, purchased CRE loans, factored receivables portfolio, and accretion of the loan purchase discount from the acquisitions) increased 13 basis points for the year ended December 31, 2018, compared to the year ended December 31, 2017. The average yield on the purchased residential loans was 2.73% for the year ended December 31, 2018, compared to 2.68% for the year ended December 31, 2017. The yield on the purchased CRE loans was 3.48% for the year ended December 31, 2018, compared to 3.51% for the year ended December 31, 2017.

· The total purchase discount on loans from Focus loan portfolio was $5.4 million on the acquisition date of August 20, 2015, of which $657,000 remains outstanding as of December 31, 2018. The total purchase discount on loans from Tri-Valley loan portfolio was $2.6 million on the acquisition date of April 6, 2018, of which $2.2 million remains outstanding as of December 31, 2018. The total purchase discount on loans from United American loan portfolio was $4.7 million on the acquisition date of May 4, 2018, of which $3.6 million remains outstanding as of December 31, 2018. The remaining purchase discount from the acquisitions was $6.5 million at December 31, 2018, compared to $1.2 million at December 31, 2017.

· The total cost of deposits was 0.21% for the year ended December 31, 2018, compared to 0.17% for the year ended December 31, 2017. The increase in the cost of deposits for the year ended December 31, 2018, compared to the year ended December 31, 2017, was primarily due to an increase in interest rates.

· There was a $7.4 million provision for loan losses for the year ended December 31, 2018, compared to a $99,000 provision for loan losses for the year ended December 31, 2017. The increase in the provision for loan losses for the year ended December 31, 2018, compared to the year ended December 31, 2017, was primarily due to a single large lending relationship that was placed on nonaccrual during the second quarter of 2018.

- Noninterest income remained flat at $9.6 million for the year ended December 31, 2018, compared to the year ended December 31, 2017. The Company received $1.3 million in proceeds from a legal settlement during the second quarter of 2018, of which $377,000 was recorded in other noninterest income, and $922,000 was credited to professional fees for recaptured legal fees previously paid by the Company. The proceeds from a legal settlement during the second quarter of 2018, higher service charges and fees on deposit accounts and gain on sales of securities, were offset by a lower increase in cash surrender value of life insurance proceeds, servicing income, and gain on sale of SBA loans for the year ended December 31, 2018, compared to the year ended December 31, 2017.

- Noninterest expense for the year ended December 31, 2018 increased to $75.5 million, compared to $60.7 million for the year ended December 31, 2017. The increase in noninterest expense for the year ended December 31, 2018, compared to the year ended December 31, 2017, was primarily due to costs related to the merger transactions and higher salaries and employee benefits as a result of annual salary increases, and additional employees and operating costs of the Tri-Valley and United American acquisitions, partially offset by lower professional fees
- The efficiency ratio for the year ended December 31, 2018 was 57.39%, compared to 54.65% for the year ended December 31, 2017.
- Income tax expense for the year ended December 31, 2018 was $13.3 million, compared to $26.5 million for the year ended December 31, 2017. The effective tax rate for the year ended December 31, 2018 was 27.4%, compared to 52.6% for the year ended December 31, 2017, primarily due to a lower federal corporate tax rate for the year ended December 31, 2018 and the $7.1 million DTA adjustment in the fourth quarter of 2017.

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 decreased (12%) to $623.6 million at December 31, 2018, from $708.1 million at December 31, 2017.
- Securities held-to-maturity, at amortized cost, totaled $377.2 million, compared to $398.3 million at December 31, 2017.
- Loans, excluding loans held-for-sale, increased $303.7 million, or 19%, to $1.89 billion at December 31, 2018, compared to $1.58 billion at December 31, 2017, which included $181.5 million in loans from United American, $112.0 million in loans from Tri-Valley, and an increase of $3.1 million in the Company's legacy portfolio, partially offset by a decrease of $7.0 million in purchased residential mortgage loans, and a decrease of $3.6 million in purchased CRE loans.
- Nonperforming assets ("NPAs") were $14.9 million, or 0.48% of total assets at December 31, 2018, compared to $2.5 million, or 0.09% of total assets at December 31, 2017. The increase in NPAs at December 31, 2018, compared to December 31, 2017, was primarily due to a single large lending relationship that was placed on nonaccrual during the second quarter of 2018.
- Classified assets were $23.4 million at December 31, 2018, compared to $25.1 million at December 31, 2017. There were no foreclosed assets at December 31, 2018 and December 31, 2017.
- The allowance for loan losses at December 31, 2018 was $27.8 million, or 1.48% of total loans, representing 187.06% of nonperforming loans. The allowance for loan losses at December 31, 2017 was $19.7 million, or 1.24% of total loans, representing 791.07% of nonperforming loans. The allowance for loan losses to total nonperforming loans decreased at December 31, 2018, compared to December 31, 2017, primarily due to a single large lending relationship that was placed on nonaccrual during the second quarter of 2018.
- Net recoveries totaled $769,000 for the year ended December 31, 2018, compared to net recoveries of $470,000 for the year ended December 31, 2017.
- Total deposits increased $154.5 million, or 6%, to $2.64 billion at December 31, 2018, compared to $2.48 billion at December 31, 2017, which included $217.6 million in deposits from United American, $82.6

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million in deposits from Tri-Valley, a decrease of $65.1 million in State of California certificates of deposit due to maturity, and a decrease of $80.5 million, or (3%), in the Company's legacy deposits, which was principally attributable to three deposit relationships totaling approximately $95.0 million.

· Deposits, excluding all time deposits and CDARS deposits, increased $202.0 million, or 9%, to $2.48 billion at December 31, 2018, compared to $2.28 billion at December 31, 2017, which included $195.8 million of deposits added from United American, $75.5 million of deposits added from Tri-Valley, partially offset by a decrease of $69.3 million, or (3%), in the Company's legacy deposits.
· 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 4.53% at December 31, 2018, compared to 6.85% at December 31, 2017.
· The loan to deposit ratio was 71.52% at December 31, 2018, compared to 63.74% at December 31, 2017.
· The Company's consolidated capital ratios exceeded regulatory guidelines and the Bank's capital ratios exceeded the regulatory guidelines for a well capitalized financial institution under the Basel III regulatory requirements at December 31, 2018.

Capital Ratios	Heritage Commerce Corp	Heritage Bank of Commerce	Well-capitalized Financial Institution Basel III Regulatory Guidelines	Fully Phased-in Basel III Minimum Requirement(1) Effective January 1, 2019
Total Risk-Based	15.0 %	14.0 %	10.0 %	10.5 %
Tier 1 Risk-Based	12.0 %	12.8 %	8.0 %	8.5 %
Common Equity Tier 1 Risk-based	12.0 %	12.8 %	6.5 %	7.0 %
Leverage	8.9 %	9.4 %	5.0 %	4.0 %

(1)Requirements for both the Company and the Bank include a 2.5% capital conservation buffer, except leverage ratio.

Deposits

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

Total deposits increased $154.5 million, or 6%, to $2.64 billion at December 31, 2018, compared to $2.48 billion at December 31, 2017, which included $217.6 million in deposits from United American, $82.6 million in deposits from Tri-Valley, a decrease of $65.1 million in State of California certificates of deposit due to maturity, and a decrease of $80.5 million, or (3%), in the Company's legacy deposits, which was principally attributable to three deposit relationships totaling approximately $95.0 million. Deposits, excluding all time deposits and CDARS deposits, increased $202.0 million, or 9%, to $2.48 billion at December 31, 2018, compared to $2.28 billion at December 31, 2017, which included $195.8 million of deposits added from United American, $75.5 million of deposits added from Tri-Valley, partially offset by a decrease of $69.3 million, or (3%), in the Company's legacy deposits.

Liquidity

Our liquidity position refers to our ability to maintain cash flows sufficient to fund operations and to meet obligations and other commitments in a timely fashion. The Company manages liquidity to be able to meet unexpected

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sudden changes in levels of its assets or deposit liabilities without maintaining excessive amounts of balance sheet liquidity. Excess balance sheet liquidity can negatively impact the Company's interest margin. At December 31, 2018, we had $164.6 million in cash and cash equivalents and approximately $657.0 million in available borrowing capacity from various sources including the Federal Home Loan Bank ("FHLB"), the Federal Reserve Bank of San Francisco ("FRB"), Federal funds facilities with several financial institutions, and a line of credit with a correspondent bank. The Company also had $789.2 million (at fair value) in unpledged securities available at December 31, 2018. Our loan to deposit ratio increased to 71.52% at December 31, 2018, compared to 63.74% at December 31, 2017.

Lending

Our lending business originates primarily through our branch offices located in our primary markets. In addition, Bay View Funding provides factoring financing and our Corporate Financing Group provides asset-based lending throughout the United States. Total loans, excluding loans held-for-sale, increased $303.7 million, or 19%, to $1.89 billion at December 31, 2018, compared to $1.58 billion at December 31, 2017, which included $181.5 million in loans from United American, $112.0 million in loans from Tri-Valley, and an increase of $3.1 million in the Company's legacy portfolio, partially offset by a decrease of $7.0 million in purchased residential mortgage loans, and a decrease of $3.6 million of purchased CRE loans. The total loan portfolio remains well diversified with C&I loans accounting for 32% of the portfolio at December 31, 2018, which included $53.6 million of factored receivables at Bay View Funding. CRE loans accounted for 52% of the total loan portfolio at December 31, 2018, of which approximately 40% was secured by owner-occupied real estate. Consumer and home equity loans accounted for 7% of total loans, land and construction loans accounted for 6% of total loans, and residential mortgage loans accounted for the remaining 3% of total loans at December 31, 2018. The commercial loan line usage was 36% at December 31, 2018, compared to 37% at December 31, 2017.

Net Interest Income

The management of interest income and expense is fundamental to the performance of the Company. Net interest income, the difference between interest income and interest expense, is the largest component of the Company's total revenue. Management closely monitors both total net interest income and the net interest margin (net interest income divided by average earning assets). Net interest income, before loan losses, increased 20% to $122.0 million for the year ended December 31, 2018, compared to $101.5 million for the year ended December 31, 2017, primarily due to the impact of the increase in loans and deposits from the Tri-Valley and United American acquisitions, in addition to the positive impact of rising interest rates.

The Company, through its asset and liability policies and practices, seeks to maximize net interest income without exposing the Company to an excessive level of interest rate risk. Interest rate risk is managed by monitoring the pricing, maturity and repricing options of all classes of interest bearing assets and liabilities. This is discussed in more detail under "Liquidity and Asset/Liability Management." In addition, we believe there are measures and initiatives we can take to improve the net interest margin, including increasing loan rates, adding floors on floating rate loans, reducing nonperforming assets, managing deposit interest rates, and reducing higher cost deposits.

The net interest margin is also adversely impacted by the reversal of interest on nonaccrual loans and the reinvestment of loan payoffs into lower yielding investment securities and other short term investments.

Management of Credit Risk

We continue to proactively identify, quantify, and manage our problem loans. Early identification of problem loans and potential future losses helps us to resolve credit issues with potentially reduced ultimate risk and ultimate losses. We maintain an allowance for loan losses in an amount that we believe is adequate to absorb probable incurred losses in the portfolio. While we strive to carefully manage and monitor credit quality and to identify loans that may be deteriorating, circumstances can change at any time for loans included in the portfolio that may result in future losses that, as of the date of the financial statements, have not yet been identified as potential problem loans. Through established credit practices, we adjust the allowance for loan losses accordingly. However, because future events are uncertain, there may be loans that deteriorate, some of which could occur in an accelerated time frame. As a result, future additions to the allowance for loan losses may be necessary. Because the loan portfolio contains a number of commercial loans, commercial real estate loans, construction and land development loans with relatively large balances, deterioration in the credit quality of one or more of these loans may require a significant increase to the allowance for loan losses. Future additions to the allowance may also be required based on changes in the financial condition of borrowers, such as have resulted due to the current, and

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potentially worsening, economic conditions. Additionally, Federal and State banking regulators, as an integral part of their supervisory function, periodically review our allowance for loan losses. These regulatory agencies may require us to recognize further loan loss provisions or charge offs based upon their judgments, which may be different from ours. Any increase in the allowance for loan losses would have an adverse effect, which may be material, on our financial condition and results of operation. Further discussion of the management of credit risk appears under “Provision for Loan Losses” and “Allowance for Loan Losses.”

In June 2016, the Financial Accounting Standards Board issued new guidance on measurement of credit losses on financial instruments, which is the final guidance on the new current expected credit loss (“CECL”) model. The new guidance replaces the incurred loss impairment methodology in current GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to estimate future credit loss estimates. While early application is permitted for fiscal years beginning after December 15, 2018, the Company plans to adopt this standard on January 1, 2020. The Company has established a company-wide, cross-functional governance structure, which oversees overall strategy for implementation of CECL. We are currently evaluating various loss methodologies to determine their correlation to our various loan categories historical performance. In the first quarter of 2018, we contracted with a third party vendor to provide a model and assist with assessing processes, portfolio segmentation, and model development. The Company also continues to believe that the adoption of the standard will result in an overall increase in the allowance for loan losses to cover credit losses over the estimated life of the financial assets. However, the magnitude of the increase in its allowance for loan losses at the adoption date will depend upon the nature and characteristics of the portfolio at the adoption date, as well as macroeconomic conditions and forecasts at that time. Further discussion of the adoption of CECL appears in Note 1 – Summary of Significant Accounting Policies – Newly Issued, but not yet Effective Accounting Standards in the financial statements in this Form 10-K.

Noninterest Income

While interest income remains the largest single component of total revenues, noninterest income is an important component. A portion of the Company’s noninterest income is associated with its SBA lending activity, consisting of gains on the sale of loans sold in the secondary market and servicing income from loans sold with servicing retained. Noninterest income from our SBA lending activity may be affected by lower premiums and accelerated pre-payments. Other sources of noninterest income include loan servicing fees, service charges and fees, cash surrender value from company owned life insurance policies, and gains on the sale of securities.

Noninterest Expense

Management considers the control of operating expenses to be a critical element of the Company’s performance. Noninterest expense for the year ended December 31, 2018 increased to $75.5 million, compared to $60.7 million for the year ended December 31, 2017, was primarily due to costs related to the merger transactions and higher salaries and employee benefits as a result of annual salary increases, and additional employees and operating costs of the Tri-Valley and United American acquisitions, partially offset by lower professional fees.

Capital Management

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

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

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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.

	Year Ended December 31, 2018			2017			2016		
	Average Balance	Interest Income / Expense	Average Yield / Rate	Average Balance	Interest Income / Expense	Average Yield / Rate	Average Balance	Interest Income / Expense	Aver Yiel Rate
	(Dollars in thousands)								
gross (1)(2)	$ 1,801,015	105,635	5.87 %	$ 1,531,922	86,346	5.64 %	$ 1,422,707	$ 79,284	5.57
es — taxable	669,994	15,211	2.27 %	636,160	13,724	2.16 %	501,347	10,432	2.08
es — exempt deral tax (3)	87,639	2,817	3.21 %	89,762	3,471	3.87 %	91,822	3,523	3.84
nvestments, -bearing s er financial ons and funds sold	285,702	6,774	2.37 %	318,025	4,585	1.44 %	228,293	2,425	1.06
terest earning 3)	2,844,350	130,437	4.59 %	2,575,869	108,126	4.20 %	2,244,169	95,664	4.26
d due from	38,665			33,542			33,899		
s and ent, net	7,298			7,553			7,624		
ll and other ole assets	82,398			51,932			53,445		
ssets	82,925			86,722			86,064		
sets	$ 3,055,636			$ 2,755,618			$ 2,425,201		
es and lders' equity: s:									
l, rest-bearing	$ 1,029,860			$ 944,275			$ 824,763		
l, -bearing	658,386	1,885	0.29 %	586,778	1,208	0.21 %	511,595	1,026	0.20
and money	777,749	2,701	0.35 %	653,636	1,534	0.23 %	526,227	1,127	0.21
eposits — under	21,375	80	0.37 %	19,789	57	0.29 %	22,079	65	0.29

eposits — $100 r	130,548	830	0.64 %	187,298	1,188	0.63 %	209,972	913	0.43
eposits — d	—	—	N/A	—	—	N/A	7,590	62	0.82
S — -bearing , money t and time s	15,369	10	0.07 %	13,941	4	0.03 %	8,232	6	0.07
-bearing s	1,603,427	5,506	0.34 %	1,461,442	3,991	0.27 %	1,285,695	3,199	0.25
eposits	2,633,287	5,506	0.21 %	2,405,717	3,991	0.17 %	2,110,458	3,199	0.15
nated debt, suance costs	39,270	2,314	5.89 %	23,266	1,394	5.99 %	—	—	0.00
rm ngs	106	2	1.89 %	75	2	2.67 %	490	12	2.45
-bearing es	1,642,803	7,822	0.48 %	1,484,783	5,387	0.36 %	1,286,185	3,211	0.25
-bearing es and , erest-bearing f funds	2,672,663	7,822	0.29 %	2,429,058	5,387	0.22 %	2,110,948	3,211	0.15
abilities	55,416			57,670			58,666		
abilities	2,728,079			2,486,728			2,169,614		
lders' equity	327,557			268,890			255,587		
abilities and lders' equity	$ 3,055,636			$ 2,755,618			$ 2,425,201		
rest income rgin		122,615	4.31 %		102,739	3.99 %		92,453	4.12
equivalent ent (3)		(592)			(1,215)			(1,233)	
rest income		$ 122,023			$ 101,524			$ 91,220	

(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 (amortization) of deferred loan fees (costs) into loan interest income was $375,000 for the year ended December 31, 2018, compared to $533,000 for the year ended December 31, 2017, and $168,000 for the year ended December 31, 2016.

(3) Reflects tax equivalent adjustment for Federal tax exempt income based on a 21% tax rate for the year ended December 31, 2018, and a 35% tax rate for the years ended December 31, 2017 and 2016.

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

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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.

	2018 vs. 2017 Increase (Decrease) Due to Change in:			2017 vs. 2016 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	$ 15,711	$ 3,578	$ 19,289	$ 6,105	$ 957	$ 7,062
Securities — taxable	770	717	1,487	2,895	397	3,292
Securities — exempt from Federal tax (1)	(64)	(590)	(654)	(83)	31	(52)
Other investments, interest-bearing deposits in other financial institutions and Federal funds sold	(763)	2,952	2,189	1,298	862	2,160
Total interest income on interest-earning assets (1)	15,654	6,657	22,311	10,215	2,247	12,462
Expense from the interest-bearing liabilities:						
Demand, interest-bearing	183	494	677	134	48	182
Savings and money market	413	754	1,167	324	83	407
Time deposits — under $100	7	16	23	(7)	(1)	(8)
Time deposits — $100 and over	(369)	11	(358)	(135)	410	275
Time deposits — brokered	—	—	—	(62)	—	(62)
CDARS — interest-bearing demand, money market and time deposits	—	6	6	2	(4)	(2)
Subordinated debt, net of issuance costs	944	(24)	920	1,394	—	1,394
Short-term borrowings	1	(1)	—	(11)	1	(10)
Total interest expense on interest-bearing liabilities	1,179	1,256	2,435	1,639	537	2,176
Net interest income (1)	$ 14,475	$ 5,401	19,876	$ 8,576	$ 1,710	10,286
Less tax equivalent adjustment (1)			623			18
Net interest income			$ 20,499			$ 10,304

(1) Reflects tax equivalent adjustment for Federal tax exempt income based on a 21% tax rate for the year ended December 31, 2018, and a 35% tax rate for the years ended December 31, 2017 and 2016.

The Company’s net interest margin (FTE), expressed as a percentage of average earning assets, increased 32 basis points to 4.31% for the year ended December 31, 2018, compared to 3.99% for the year ended December 31, 2017, primarily due to a higher average balance of loans and securities, an increase in the accretion of the loan purchase discount into loan interest income from the Tri-Valley and United American acquisitions in the second quarter of 2018, the impact of increases in the prime rate and the rate on overnight funds.

The Company’s net interest margin (FTE) contracted 13 basis points to 3.99% for the year ended December 31, 2017, compared to 4.12% for the year ended December 31, 2016, primarily due to a higher average balance of lower yielding excess funds at the Federal Reserve Bank, the issuance of the subordinated debt, and a decrease in the accretion of the loan purchase discount into loan interest income from the 2015 Focus acquisition. This was partially offset by an increase in the average balances of loans and securities, and the impact of increases in the prime rate on loan yields and overnight funds. The average balance of other investments and interest-bearing deposits in other financial institutions increased $89.7 million to $318.0 million for the year ended December 31, 2017, compared to $228.3 million for the year ended December 31, 2016.

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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,											
	2018				2017				2016			
	Average Balance	Interest Income	Average Yield		Average Balance	Interest Income	Average Yield		Average Balance	Interest Income	Average Yield	
	(Dollars in thousands)											
ans, core nk and asset- ased lending	$ 1,670,065	$ 86,610	5.19	%	$ 1,402,628	$ 71,011	5.06	%	$ 1,350,949	$ 64,647	4.79	%
y View nding tored eivables	59,220	14,698	24.82	%	45,794	11,884	25.95	%	46,425	12,256	26.40	%
sidential ortgages	40,998	1,118	2.73	%	48,266	1,294	2.68	%	24,916	710	2.85	%
rchased CRE ans	36,080	1,257	3.48	%	36,807	1,292	3.51	%	3,461	122	3.52	%
an credit rk	(5,348)	1,952	0.12	%	(1,573)	865	0.06	%	(3,044)	1,549	0.11	%
tal loans cludes loans eld-for-sale)	$ 1,801,015	$ 105,635	5.87	%	$ 1,531,922	$ 86,346	5.64	%	$ 1,422,707	$ 79,284	5.57	%

The average yield on the total loan portfolio increased to 5.87% for the year ended December 31, 2018, compared to 5.64% for the year ended December 31, 2017, primarily due to an increase in accretion of the loan purchase discount into loan interest income from the acquisitions, and increases in the prime rate. The average yield on the loan portfolio increased to 5.64 % for the for the year ended December 31, 2017, compared to 5.57% for the year ended December 31, 2016, primarily due to increases in the prime rate, partially offset by the impact of the lower yielding purchased residential mortgage loans and purchased CRE loans, a lower yield on the factored receivables portfolio, and a decrease in the accretion of the loan purchase discount into loan interest income from the Focus transaction.

The total purchase discount on loans from Focus loan portfolio was $5.4 million on the acquisition date of August 20, 2015, of which $657,000 remains outstanding as of December 31, 2018. The total purchase discount on loans from Tri-Valley loan portfolio was $2.6 million on the acquisition date of April 6, 2018, of which $2.2 million remains outstanding as of December 31, 2018. The total purchase discount on loans from United American loan portfolio was $4.7 million on the acquisition date of May 4, 2018, of which $3.6 million remains outstanding as of December 31, 2018. The remaining purchase discount from the three acquisitions was $6.5 million at December 31, 2018, compared to $1.2 million at December 31, 2017.

The total cost of deposits was 0.21% for the year ended December 31, 2018, compared to 0.17% for the year ended December 31, 2017.

Net interest income, before provision for loan losses, for the year ended December 31, 2018 increased 20% to $122.0 million, compared to $101.5 million for the year ended December 31, 2017, primarily due to the impact of the increase in loans and deposits from the Tri-Valley and United American acquisitions, in addition to organic loan growth and the positive impact of rising interest rates. Net interest income for the year ended December 31, 2017 increased 11% to $101.5 million, compared to $91.2 million for the year ended December 31, 2016, primarily due to an increase in the average balance of loans, investment securities, and other interest earning assets.

Provision for Loan Losses

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

There was a $7.4 million provision for loan losses for the year ended December 31, 2018, compared to $99,000 provision for loan losses for the year ended December 31, 2017, and a $1.2 million provision for loan losses for the year ended December 31, 2016. The increase in the provision for loan losses for the year ended December 31, 2018, compared to the year ended December 31, 2017, was primarily due to a single large lending relationship that was placed on nonaccrual during the second quarter of 2018. Provisions for loan losses are charged to operations to bring the allowance for loan losses to a level deemed appropriate by the Company based on the factors discussed under "Allowance for Loan Losses."

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The allowance for loan losses totaled $27.8 million, or 1.48% of total loans at December 31, 2018, compared to $19.7 million, or 1.24% of total loans at December 31, 2017, and $19.1 million, or 1.27% of total loans at December 31, 2016. The allowance for loan losses to total nonperforming loans was 187.06% at December 31, 2018, compared to 791.07% at December 31, 2017, and 624.03% at December 31, 2016. The allowance for loan losses to total nonperforming loans decreased at December 31, 2018, compared to December 31, 2017, primarily due to a single large lending relationship that was placed on nonaccrual during the second quarter of 2018. Net recoveries totaled $769,000 for the year ended December 31, 2018, compared to net recoveries of $470,000 for the year ended December 31, 2017, and net charge-offs of $1.1 million for the year ended December 31, 2016.

Noninterest Income

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

	Year Ended December 31,			Increase (decrease) 2018 versus 2017		Increase (Decrease) 2017 versus 2016	
	2018	2017	2016	Amount	Percent	Amount	Percent
	(Dollars in thousands)						
Service charges and fees on deposit accounts	$ 4,113	$ 3,231	$ 3,116	$ 882	27 %	$ 115	4 %
Increase in cash surrender value of life insurance	1,045	1,666	1,747	(621)	(37) %	(81)	(5) %
Servicing income	709	973	1,398	(264)	(27) %	(425)	(30) %
Gain on sales of SBA loans	698	1,108	796	(410)	(37) %	312	39 %
Gain (loss) on sales of securities	266	(6)	1,099	272	4,533 %	(1,105)	(101) %
Gain on proceeds from company-owned life insurance	—	—	1,119	—	N/A	(1,119)	(100) %
Other	2,743	2,640	2,350	103	4 %	290	12 %
Total	$ 9,574	$ 9,612	$ 11,625	$ (38)	0 %	$ (2,013)	(17) %

For the year ended December 31, 2018, noninterest income remained relatively flat at $9.6 million, compared to the year ended December 31, 2017. The Company received $1.3 million in proceeds from a legal settlement during the second quarter of 2018, of which $377,000 was recorded in other noninterest income, and $922,000 was credited to professional fees for recaptured legal fees previously paid by the Company. The proceeds from a legal settlement during the second quarter of 2018, higher service charges and fees on deposit accounts and gain on sales of securities, were offset by a lower increase in cash surrender value of life insurance proceeds, servicing income, and gain on sale of SBA loans for the year ended December 31, 2018, compared to the year ended December 31, 2017.

For the year ended December 31, 2017, noninterest income was $9.6 million, compared to $11.6 million for the year ended December 31, 2016. The decrease in total noninterest income for the year ended December 31, 2017, compared to the year ended December 31, 2016, was primarily due to a $1.1 million gain on proceeds from company-owned life insurance and a $1.1 million gain on sales of securities in the year ended December 31, 2016, and lower servicing income in the year ended December 31, 2017. The decrease was partially offset by increases in fee income from Bay View Funding during the year ended December 31, 2017, which is included in other noninterest income within the consolidated income statements.

Historically, 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 2018, SBA loan sales resulted in a $698,000 gain, compared to a $1.1 million gain on sales of SBA loans in 2017, and a $796,000 gain on sales of SBA loans in 2016.

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) 2018 versus 2017		Increase (Decrease) 2017 versus 2016	
	2018	2017	2016	Amount	Percent	Amount	Percent
	(Dollars in thousands)						
Salaries and employee benefits	$ 40,193	$ 35,719	$ 33,386	$ 4,474	13 %	$ 2,333	7 %
Other acquisition and integration related costs	5,598	671	—	4,927	734 %	671	N/A
Occupancy and equipment	5,411	4,578	4,378	833	18 %	200	5 %
Severance and retention acquisition costs (1)	3,569	—	—	3,569	N/A	—	N/A
Professional fees	2,891	2,982	3,471	(91)	(3) %	(489)	(14) %
Software subscriptions	2,343	1,831	1,573	512	28 %	258	16 %
Data processing	1,978	1,483	1,331	495	33 %	152	11 %
Amortization of intangible assets	1,943	1,361	1,568	582	43 %	(207)	(13) %
Insurance expense	1,685	1,529	1,275	156	10 %	254	20 %
Recovery of legal fees (2)	(922)	—	—	(922)	N/A	—	N/A
Other	10,832	10,584	10,657	248	2 %	(73)	(1) %
Total	$ 75,521	$ 60,738	$ 57,639	$ 14,783	24 %	$ 3,099	5 %

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

(2) Included in Professional fees in the Consolidated Statements of Income.

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

	Year Ended December 31, 2018			2017			2016		
	Amount	Percent of Total		Amount	Percent of Total		Amount	Percent of Total	
	(Dollars in thousands)								
Salaries and employee benefits	$ 40,193	53	%	$ 35,719	59	%	$ 33,386	58	%
Other acquisition and integration related costs	5,598	7	%	671	1	%	—	0	%
Occupancy and equipment	5,411	7	%	4,578	8	%	4,378	8	%
Severance and retention acquisition costs (1)	3,569	5	%	—	0	%	—	0	%
Professional fees	2,891	4	%	2,982	5	%	3,471	6	%
Software subscriptions	2,343	3	%	1,831	3	%	1,573	3	%
Data processing	1,978	3	%	1,483	2	%	1,331	2	%
Amortization of intangible assets	1,943	3	%	1,361	2	%	1,568	3	%
Insurance expense	1,685	2	%	1,529	3	%	1,275	2	%
Recovery of legal fees (2)	(922)	(1)	%	—	0	%	—	0	%
Other	10,832	14	%	10,584	17	%	10,657	18	%
Total	$ 75,521	100	%	$ 60,738	100	%	$ 57,639	100	%

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

(2) Included in Professional fees in the Consolidated Statements of Income.

Noninterest expense for the year ended December 31, 2018 increased 24% to $75.5 million, compared to $60.7 million for the year ended December 31, 2017, primarily due to due to costs related to the merger transactions and higher

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salaries and employee benefits as a result of annual salary increases, and additional employees and operating costs of the Tri-Valley and United American acquisitions, partially offset by lower professional fees. The Company received a recovery of $922,000 of professional fees from a legal settlement in the second quarter of 2018. Full-time equivalent employees were 302, 278, and 263 at December 31, 2018, 2017, and 2016, respectively.

Noninterest expense for the year ended December 31, 2017 increased 5% to $60.7 million, compared to $57.6 million for the year ended December 31, 2016, primarily due to higher salaries and employee benefits as a result of annual salary increases and hiring additional employees, and costs related to the merger transactions, partially offset by lower professional fees.

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 Tax Act was signed into law on December 22, 2017, which among other things reduced the federal corporate tax rate to 21% from 35%, effective January 1, 2018. The enactment of the Tax Act caused our net DTA to be revalued at the new lower tax rate with resulting tax effects accounted for in the reporting period of enactment. The Company performed an analysis and determined the value of the net DTA was reduced by $7.1 million, which was recognized as a one-time, non-cash, incremental income tax expense for the fourth quarter of 2017 and for the year ended December 31, 2018.

Also on December 22, 2017, the SEC issued Staff Accounting Bulletin ("SAB") 118, which addresses the situations where the accounting for changes in tax laws is complete, incomplete but can be reasonably estimated, and incomplete and cannot be reasonably estimated. SAB 118 also permits a measurement period up to one year from the date of enactment to refine the provisional accounting. There were no items for which the Company was unable to make a reasonable estimate for the effects of the tax law change. The Company has completed its accounting for the effects of the Tax Act on its deferred tax assets and liabilities.

The following table shows the effective income tax rates for the dates indicated:

	Year Ended December 31,		
	2018	2017	2016
Effective income tax rate	27.4%	52.6%	37.7%

The Company's Federal and state income tax expense in 2018 was $13.3 million, compared to $26.5 million in 2017, and $16.6 million in 2016. The effective tax rate for the year ended December 31, 2018 decreased compared to the year ended December 31, 2017, primarily due to lower federal corporate tax rate for 2018 and the $7.1 million DTA adjustment in the fourth quarter of 2017. The effective tax rate increased for the year ended December 31, 2017, compared to the year ended December 31, 2016, primarily due to the $7.1 million DTA adjustment in the fourth quarter of 2017.

The difference in the effective tax rate for the periods reported compared to the combined Federal and state statutory tax rate of 29.6% for the year ended December 31, 2018, and 42% for the years ended December 31, 2017 and 2016, is primarily the result of the Company's investment in life insurance policies whose earnings are not subject to taxes, tax credits related to investments in low income housing limited partnerships (net of low income housing investment losses), and tax-exempt interest income earned on municipal bonds.

In March 2016, the FASB issued new guidance intended to simplify several areas of accounting for share-based compensation programs, including the income tax impact, classification on the statement of cash flows, and forfeitures. The Company adopted the new guidance on share-based compensation during the first quarter of 2017. All excess tax benefits and tax deficiencies (including tax benefits of dividends on share based payment awards) are recognized as income tax expense or benefit on the income statement. The tax effects of exercised or vested awards are treated as discrete items in the reporting period in which they occur. The adoption of this guidance resulted in a reduction to income tax expense of ($424,000) for the year ended December 31, 2018, compared to a reduction of ($146,000) for the year ended December 31, 2017.

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 $27.1 million and $16.2 million at December 31, 2018, and December 31, 2017, 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, 2018 and December 31, 2017 will be fully realized in future years.

Business Segment Information

The following presents the Company's operating segments. 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 loan loss is allocated based on the segment's allowance for loan loss 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, 2018		
	Banking(1)	Factoring	Consolidated
	(Dollars in thousands)		
Interest income	$ 115,147	$ 14,698	$ 129,845
Intersegment interest allocations	1,856	(1,856)	—
Total interest expense	7,822	—	7,822
Net interest income	109,181	12,842	122,023
Provision for loan losses	7,224	197	7,421
Net interest income after provision	101,957	12,645	114,602
Noninterest income	8,662	912	9,574
Noninterest expense (2)	69,164	6,357	75,521
Intersegment expense allocations	753	(753)	—
Income before income taxes	42,208	6,447	48,655
Income tax expense	11,418	1,906	13,324
Net income	$ 30,790	$ 4,541	$ 35,331

Total assets	$ 3,028,721	$ 67,841	$ 3,096,562
Loans, net of deferred fees	$ 1,832,815	$ 53,590	$ 1,886,405
Goodwill	$ 70,709	$ 13,044	$ 83,753

(3) Includes the holding company's results of operations
(4) The banking segment's noninterest expense includes acquisition costs of $9,167,000.

	Year Ended December 31, 2017		
	Banking(1)	Factoring	Consolidated
	(Dollars in thousands)		
Interest income	$ 95,027	$ 11,884	$ 106,911
Intersegment interest allocations	1,126	(1,126)	—
Total interest expense	5,387	—	5,387
Net interest income	90,766	10,758	101,524
Provision for loan losses	102	(3)	99
Net interest income after provision	90,664	10,761	101,425
Noninterest income	8,559	1,053	9,612
Noninterest expense (2)	53,860	6,878	60,738
Intersegment expense allocations	528	(528)	—
Income before income taxes	45,891	4,408	50,299
Income tax expense (3)	24,266	2,205	26,471
Net income	$ 21,625	$ 2,203	$ 23,828
Total assets	$ 2,780,286	$ 63,166	$ 2,843,452
Loans, net of deferred fees	$ 1,533,841	$ 48,826	$ 1,582,667
Goodwill	$ 32,620	$ 13,044	$ 45,664

(1) Includes the holding company's results of operations

(2) Includes $671,000 pre-tax acquisition costs related to the Tri-Valley and United American proposed mergers in the banking segment.

(3)Includes $7.1 million of expense associated with remeasurement of the net DTA, of which $6.7 million was in the banking segment, and $354,000 was in the factoring segment

	Year Ended December 31, 2016		
	Banking(1)	Factoring	Consolidated
	(Dollars in thousands)		
Interest income	$ 82,175	$ 12,256	$ 94,431
Intersegment interest allocations	1,163	(1,163)	—
Total interest expense	3,211	—	3,211
Net interest income	80,127	11,093	91,220
Provision for loan losses	1,181	56	1,237
Net interest income after provision	78,946	11,037	89,983
Noninterest income	10,821	804	11,625
Noninterest expense	50,298	7,341	57,639
Intersegment expense allocations	804	(804)	—
Income before income taxes	40,273	3,696	43,969
Income tax expense	15,036	1,552	16,588
Net income	$ 25,237	$ 2,144	$ 27,381

Total assets	$ 2,507,121	$ 63,759	$ 2,570,880
Loans, net of deferred fees	$ 1,452,991	$ 49,616	$ 1,502,607
Goodwill	$ 32,620	$ 13,044	$ 45,664

(1) Includes the holding company's results of operation

Banking. Our banking segment's net income increased to $30.8 million for the year ended December 31, 2018, compared to net income of $21.6 million for the year ended December 31, 2017, primarily due to the impact of the increase in loans and deposits from the Tri-Valley and United American acquisitions, in addition to organic loan growth and the positive impact of rising interest rates. The provision for loan losses increased to $7.2 million for the year ended December 31, 2018, compared to a provision for loan losses of $102,000 for the year ended December 31, 2017, primarily due to a single large lending relationship that was placed on nonaccrual during the second quarter of 2018. Noninterest income remained relatively flat for the year ended December 31, 2018, compared to the year ended December 31, 2017. For the year ended December 31, 2018, noninterest expense increased to $69.2 million, compared to $53.9 million for the year ended December 31, 2017, primarily due to costs related to the merger transactions and higher salaries and employee benefits as a result of annual salary increases, and additional employees and operating costs of the Tri-Valley and United American acquisitions, partially offset by lower professional fees.

For the year ended December 31, 2017, our banking segment's net income decreased to $21.6 million, compared to net income of $25.2 million for the year ended December 31, 2016, primarily due to pre-tax acquisition costs of $671,000 related to the Tri-Valley and United American proposed mergers and a $6.7 million revaluation of the net DTA due to enactment of the Tax Act. For the year ended December 31, 2017, net interest income increased to $90.8 million, compared to $80.1 million for the year ended December 31, 2016, primarily as a result of an increase in the average balance of loans, investment securities, and other interest earning assets. The provision for loan losses was $102,000 for the year ended December 31, 2017, compared to a provision for loan losses of $1.2 million for the year ended December 31, 2016. Noninterest income decreased to $8.6 million for the year ended December 31, 2017, compared to $10.8 million for the year ended December 31, 2016, primarily due to a $1.1 million gain on proceeds from company-owned life insurance and a $1.1 million gain on sales of investment securities for the year ended 2016, and lower servicing income for the year ended December 31, 2017. For the year ended December 31, 2017, noninterest expense increased to $53.9 million, compared to $50.3 million for the year ended December 31, 2016, primarily due to higher salaries and employee benefits as a result of annual salary increases and hiring additional employees, and costs related to the proposed merger transactions. Income tax expense of $24.3 million for the year ended December 31, 2017 included a non-cash additional tax expense of $6.7 million, which resulted from the remeasurement of our net DTA. Income tax expense for the year ended December 31, 2016 was $15.0 million.

Factoring. 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 average life of the factored receivables was 36 days for the years ended December 31, 2018 and 2017, and 35 days for the year ended December 31, 2016. Net interest income for the year ended December 31, 2018 increased to $12.8 million, compared to $10.8 million for the year ended December 31, 2017, primarily due to an increase in the average balance of factored receivables outstanding, partially offset by a decrease in the average yield on the factored receivables portfolio. For the year ended December 31, 2017, net interest income decreased to $10.8 million, compared to $11.1 million for the year ended December 31, 2016, primarily due to a decrease in the average yield on the factored receivables portfolio, and a decrease in the average balance of factored receivables outstanding. Income tax expense for the year ended December 31, 2017, included a $354,000 remeasurement of the net DTA due to enactment of the Tax Act.

FINANCIAL CONDITION

As of December 31, 2018, total assets increased 9% to $3.10 billion, compared to $2.84 billion at December 31, 2017. Securities available-for-sale, at fair value, were $459.0 million at December 31, 2018, an increase of 17% from $391.9 million at December 31, 2017. Securities held-to-maturity, at amortized cost, were $377.2 million at December 31, 2018, a decrease of (5%) from $398.3 million at December 31, 2017. Total loans, excluding loans held-for-sale, increased $303.7 million, or 19%, to $1.89 billion at December 31, 2018, compared to $1.58 billion at December 31, 2017, which included $181.5 million in loans from United American, $112.0 million in loans from Tri-Valley, and an increase of $3.1 million in the Company's legacy portfolio, partially offset by a decrease of $7.0 million in purchased residential mortgage loans, and a decrease of $3.6 million in purchased CRE loans.

Total deposits increased $154.5 million, or 6%, to $2.64 billion at December 31, 2018, compared to $2.48 billion at December 31, 2017, which included $217.6 million in deposits from United American, $82.6 million in deposits from Tri-Valley, a decrease of $65.1 million in State of California certificates of deposit due to maturity, and a decrease of $80.5 million, or (3%), in the Company's legacy deposits, which was principally attributable to three deposit relationships totaling approximately $95 million. Deposits, excluding all time deposits and CDARS deposits, increased $202.0 million, or 9%, to $2.48 billion at December 31, 2018, from $2.28 billion at December 31, 2017, which included $195.8 million of deposits added from United American, $75.5 million of deposits added from Tri-Valley, partially offset by a decrease of $69.3 million, or (3%), in the Company's legacy deposits.

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Securities Portfolio

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

	December 31, 2018	2017	2016
	(Dollars in thousands)		
Securities available-for-sale (at fair value):			
Agency mortgage-backed securities	$ 302,854	$ 374,733	$ 290,989
U.S. Treasury	148,753	—	—
U.S. Government sponsored entities	7,436	—	—
Trust preferred securities	—	17,119	15,600
Total	$ 459,043	$ 391,852	$ 306,589
Securities held-to-maturity (at amortized cost):			
Agency mortgage-backed securities	$ 291,241	$ 309,616	$ 233,409
Municipals — exempt from Federal tax	85,957	88,725	90,601
	$ 377,198	$ 398,341	$ 324,010

The table below summarizes the weighted average life and weighted average yields of securities as of December 31, 2018:

	Weighted Average Life Within One Year or Less Amount	Yield	After One and Within Five Years Amount	Yield	After Five and Within Ten Years Amount	Yield	After Ten Years Amount	Yield	Total Amou
	(Dollars in thousands)								
ble-for-sale (at fair value):									
e-backed securities	$ —	N/A	$ 188,998	2.28 %	$ 113,856	2.47 %	$ —	N/A	$ 302,
	—	N/A	148,753	2.80 %	—	N/A	—	N/A	148,
t sponsored entities	1,995	2.63 %	5,441	2.65 %	—	N/A	—	N/A	7,43
	$ 1,995	2.63 %	$ 343,192	2.51 %	$ 113,856	2.47 %	$ —	N/A	$ 459,
-maturity (at amortized cost):									
e-backed securities	$ —	N/A	$ 137,468	1.90 %	$ 106,384	2.35 %	$ 47,389	3.38 %	$ 291,
xempt from Federal tax (1)	3,399	3.63 %	31,426	3.35 %	12,779	3.06 %	38,353	3.17 %	85,9
	$ 3,399	3.63 %	$ 168,894	2.17 %	$ 119,163	2.43 %	$ 85,742	3.29 %	$ 377,

(1)Reflects tax equivalent yield based on a 21% Federal tax rate.

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

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

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

The investment securities available-for-sale portfolio totaled $459.0 million at December 31, 2018, an increase of 17% from $391.9 million at December 31, 2018. At December 31, 2018, the Company's securities available-for-sale portfolio, at fair value, was comprised of $302.9 million agency mortgage-backed securities (all issued by U.S. Government sponsored entities), $148.7 million U.S. Treasury, and $7.4 million U.S. Government sponsored entities debt securities. The pre-tax unrealized loss on securities available-for-sale at December 31, 2018 was ($7.7) million, compared to a pre-tax unrealized loss on securities available-for-sale of ($1.5) million at December 31, 2017, and a pre-tax unrealized loss on securities available-for-sale of ($2.0) million at December 31, 2016. All other factors remaining the same, when market interest rates are rising, the Company will experience a lower unrealized gain (or a higher unrealized loss) on the securities portfolio.

Investment securities available-for-sale acquired from United American totaled $63.7 million, at fair value, on May 4, 2018. Subsequent to closing, the Company sold $55.4 million of these securities, for a gain on sale of securities of $179,000 in the second quarter of 2018. During the year ended December 31, 2018, the Company purchased $162.8 million of investment securities available for sale, which consisted of $15.2 million of Federal Home Loan Mortgage Corporation ("FHLMC") securities, with an average book yield of 2.59%, and $147.6 million of U.S. Treasuries, with an average book yield of 2.82%.

At December 31, 2018, investment securities held-to-maturity totaled $377.2 million, a decrease of (5%) from $398.3 million at December 31, 2017. At December 31, 2018, the Company's securities held-to-maturity portfolio, at amortized cost, was comprised of $291.2 million agency mortgage-backed securities, and $86.0 million tax-exempt municipal bonds.

During the year ended December 31, 2018, the Company purchased $31.5 million of investment securities held-to-maturity, which consisted of $6.3 million FHLMC securities, with an average book yield of 3.39%, and $25.1 million of FNMA securities, with an average book yield of 3.43%.

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

Loans

The Company's loans represent the largest portion of earning assets, substantially greater than the securities portfolio or any other asset category, and the quality and diversification of the loan portfolio is an important consideration when reviewing the Company's financial condition. Gross loans, excluding loans held-for-sale, represented 61% of total assets at December 31, 2018 and 56% at December 31, 2017. The ratio of loans to deposits increased to 71.52% at December 31, 2018 from 63.74% at December 31, 2017.

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.

ber 31,														
	% to Total		2017	% to Total		2016	% to Total		2015	% to Total		2014
s in thousands)												
'63	32	%	$ 573,296	36	%	$ 604,331	40	%	$ 556,522	41	%	$ 462,(
067	52	%	772,867	49	%	662,228	44	%	625,665	46	%	478,
58	6	%	100,882	6	%	81,002	5	%	84,428	6	%	67,9
12	6	%	79,176	5	%	82,459	6	%	76,833	6	%	61,6
'9	3	%	44,561	3	%	52,887	4	%	—	0	%	—
3	1	%	12,395	1	%	20,460	1	%	16,010	1	%	18,8
,732	100	%	1,583,177	100	%	1,503,367	100	%	1,359,458	100	%	1,08
	—		(510)	—		(760)	—		(742)	—		(586
,405	100	%	1,582,667	100	%	1,502,607	100	%	1,358,716	100	%	1,08
48)			(19,658)			(19,089)			(18,926)			(18,:
,557			$ 1,563,009			$ 1,483,518			$ 1,339,790			$ 1,07

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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, 67% of its gross loans were secured by real property as of December 31, 2018, compared to 63% as of December 31, 2017. 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 2018, loans were sold resulting in a gain on sales of SBA loans of $698,000, compared to a gain on sales of SBA loans of $1.1 million for 2017, and $796,000 for 2016.

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 receivables is included in the Company's commercial loan portfolio. The average life of the factored receivables was 36 days for both the years ended December 31, 2018 and 2017. The balance of the purchased receivables as of December 31, 2018 and 2017 was $53.6 million and $48.8 million, respectively.

The commercial loan portfolio increased $24.5 million to $597.8 million at December 31, 2018, from $573.3 million at December 31, 2017, which included $17.8 million of loans added from United American, and $9.2 million of loans added from Tri-Valley, partially offset by a decrease of $2.6 million in the Company's legacy portfolio. The commercial loan line usage was 36% at December 31, 2018, compared to 37% at December 31, 2017.

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 loan portfolio increased $221.2 million, or 29%, to $994.1 million at December 31, 2018, compared to $772.9 million at December 31, 2017, which included $133.8 million of loans added from United American, $90.7 million of loans added from Tri-Valley, partially offset by a decrease of $3.6 million in purchased CRE loans. At December 31, 2018, approximately 40% of the CRE loan portfolio was secured by owner-occupied real estate.

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

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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 $21.5 million, or 21%, to $122.4 million at December 31, 2018, compared to $100.9 million at December 31, 2017, primarily due to organic growth of $17.5 million, and $4.0 million of loans added from United American.

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 $29.9 million, or 38%, to $109.1 million at December 31, 2018, compared to $79.2 million at December 31, 2017, which included $29.5 million of loans added from United American, and $12.2 million of loans added from Tri-Valley, partially offset by a decrease of $11.7 million in the Company's legacy portfolio.

Residential mortgage loans increased $6.4 million, 14%, to $51.0 million at December 31, 2018, compared to $44.6 million at December 31, 2017, primarily due to $13.4 million of loans added from United American, partially offset by a $7.0 million decrease in purchased residential mortgage loans.

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, real property in the instances of home equity loans or lines of credit.

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 $61.9 million and $103.1 million at December 31, 2018, respectively.

Loan Maturities

The following table presents the maturity distribution of the Company's loans (excluding loans held for sale), as of December 31, 2018. 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, 2018, approximately 52% of the Company's loan portfolio consisted of floating interest rate loans.

	Due in One Year or Less	Over One Year But Less than Five Years	Over Five Years	Total
	(Dollars in thousands)			
Commercial	$ 477,742	99,426	20,595	$ 597,763
Real estate:				
CRE	120,724	456,649	416,694	994,067
Land and construction	119,470	1,626	1,262	122,358
Home equity	102,734	3,102	3,276	109,112

Residential mortgages	1,539	6,588	42,852	50,979
Consumer	12,228	223	2	12,453
Loans	$ 834,437	$ 567,614	$ 484,681	$ 1,886,732
Loans with variable interest rates	$ 741,586	167,752	69,961	$ 979,299
Loans with fixed interest rates	92,851	399,862	414,720	907,433
Loans	$ 834,437	$ 567,614	$ 484,681	$ 1,886,732

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Loan Servicing

As of December 31, 2018, 2017, and 2016 there were $104.0 million, $139.1 million, and $164.5 million, respectively, of SBA loans that were serviced by the Company for others. Activity for loan servicing rights was as follows:

	2018	2017	2016
	(Dollars in thousands)		
Beginning of period balance	$ 1,373	$ 1,854	$ 2,209
Additions	200	278	219
Amortization	(702)	(759)	(574)
End of period balance	$ 871	$ 1,373	$ 1,854

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, 2018 and 2017, as the fair market value of the assets was greater than the carrying value.

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

	2018	2017	2016
	(Dollars in thousands)		
Beginning of period balance	$ 968	$ 1,067	$ 1,367
Unrealized holding loss	(400)	(99)	(300)
End of period balance	$ 568	$ 968	$ 1,067

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, 2018, key economic assumptions and the sensitivity of the 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:

Carrying amount/fair value of Interest-Only (I/O) strip	$ 568
Prepayment speed assumption (annual rate)	10.9
Impact on fair value of 10% adverse change in prepayment speed (CPR 12.0%)	$ (8)
Impact on fair value of 20% adverse change in prepayment speed (CPR 13.1%)	$ (15)
Residual cash flow discount rate assumption (annual)	16.4%
Impact on fair value of 1% adverse change in discount rate (18.0% discount rate)	$ (16)
Impact on fair value of 2% adverse change in discount rate (19.7% discount rate)	$ (31)

Credit Quality

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

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

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

Nonperforming assets are comprised of the following: loans for which the Company is no longer accruing interest; restructured loans which have been current under six months; loans 90 days or more past due and still accruing interest (although they are generally placed on nonaccrual when they become 90 days past due, unless they are both well secured and in the process of collection); and foreclosed assets. Past due loans 30 days or greater totaled $8.9 million and $6.9 million at December 31, 2018 and December 31, 2017, respectively, of which $430,000 and $1.4 million were on nonaccrual. There were also $13.3 million and $840,000 loans less than 30 days past due included in nonaccrual loans held-for-investment, at December 31, 2018 and December 31, 2017, 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,				
	2018	2017	2016	2015	2014
	(Dollars in thousands)				
Nonaccrual loans — held-for-investment	$ 13,699	$ 2,250	$ 3,059	$ 4,716	$ 5,855
Restructured and loans 90 days past due and still accruing	1,188	235	—	1,662	—
Total nonperforming loans	14,887	2,485	3,059	6,378	5,855
Foreclosed assets	—	—	229	364	696
Total nonperforming assets	$ 14,887	$ 2,485	$ 3,288	$ 6,742	$ 6,551
Nonperforming assets as a percentage of loans plus foreclosed assets	0.79 %	0.16 %	0.22 %	0.50 %	0.60 %
Nonperforming assets as a percentage of total assets	0.48 %	0.09 %	0.13 %	0.29 %	0.41 %

Nonperforming assets were $14.9 million, or 0.48% of total assets, at December 31, 2018 compared to $2.5 million, or 0.09% of total assets, at December 31, 2017. The increase in nonperforming assets at December 31, 2018, compared to December 31, 2017, was primarily due to a single large lending relationship that was placed on nonaccrual during the second quarter of 2018. At December 31, 2018, the recorded investment of this lending relationship was $12.0 million, and the Company had a $6.7 million specific loan loss reserve allocated for this lending relationship. There were no foreclosed assets at December 31, 2018 and December 31, 2017.

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

	December 31, 2018			December 31, 2017		
	Nonaccrual	Restructured and Loans over 90 Days Past Due and Still Accruing	Total	Nonaccrual	Restructured and Loans over 90 Days Past Due and Still Accruing	Total
	(Dollars in thousands)					
Commercial	$ 8,279	$ 963	$ 9,242	$		