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

FORM 10-K

(MARK ONE)

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

For the fiscal year ended December 31, 2007

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

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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 [X]

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 [X]

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 [X] 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. [X]

Indicate by check mark whether the Registrant is an large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large accelerated filer [ ] Accelerated filer [X] Non-accelerated filer [ ] Smaller Reporting Company [ ]

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

The aggregate market value of the stock held by non-affiliates of the Registrant, based upon the closing price of its common stock as of June 29, 2007 ($23.68 per share), as reported on the Nasdaq Global Select Market, was approximately $262 million.

As of February 15, 2008, there were 12,785,944 shares of the Registrant's common stock (no par value) outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

DOCUMENTS INCORPORATED	PARTS OF FORM 10-K INTO WHICH INCORPORATED
Definitive proxy statement for the Company's 2008 Annual Meeting of Shareholders to be filed within 120 days of the end of the fiscal year ended December 31, 2007	Part III

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HERITAGE COMMERCE CORP
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ANNUAL REPORT ON FORM 10-K
FOR YEAR ENDED DECEMBER 31, 2007

PART I

ITEM 1 - BUSINESS

Discussions of certain matters in this Report on Form 10-K may constitute forward looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), and as such, may involve risks and uncertainties. Forward-looking statements, which are based on certain assumptions and describe future plans, strategies, and expectations, are generally identifiable by the use of words such as “believe”, “expect”, “intend”, “anticipate”, “estimate”, “project”, “assume,” “plan,” “forecast” or similar expressions. These forward-looking statements relate to, among other things, expectations of the business environment in which the Company operates, projections of future performance, potential future performance, potential future credit experience, perceived opportunities in the market, and statements regarding the Company’s mission and vision. The Company’s actual results, performance, and achievements may differ materially from the results, performance, and achievements expressed or implied in such forward-looking statements due to a wide range of factors. The factors include, but are not limited to changes in interest rates, reducing interest margins or increasing interest rate risk, general economic conditions nationally or in the State of California, legislative and regulatory changes adversely affecting the business in which the Company operates, monetary and fiscal policies of the US Government, real estate valuations, the availability of sources of liquidity at a reasonable cost, competition in the financial services industry, the occurrence of events such as the terrorist acts of September 11, 2001, and other risks. All of the Company’s operations and most of its customers are located in California. In addition, acts and threats of terrorism or the impact of military conflicts have increased the uncertainty related to the national and California economic outlook and could have an effect on the future operations of the Company or its customers, including borrowers. See Item 1A – Risk Factors for further discussion of factors that could cause actual results to differ from forward-looking statements. The Company does not undertake, and specifically disclaims any obligation, to update any forward-looking statements to reflect occurrences or unanticipated events or circumstances after the date of such statements.

GENERAL

Heritage Commerce Corp (the “Company”) is registered with the Board of Governors of the Federal Reserve System (“FRB”) as a Bank Holding Company under the Bank Holding Company Act (“BHCA”). The Company was organized in 1997 to be the holding company for Heritage Bank of Commerce. Subsequent to 1997, the Company became the holding company for Heritage Bank East Bay (“HBEB”), Heritage Bank South Valley (“HBSV”), and Bank of Los Altos (“BLA”). On January 1, 2003, HBEB, HBSV, and BLA were merged into Heritage Bank of Commerce (”HBC”).

The Company’s only other direct subsidiaries are Heritage Capital Trust I (formed 2000), Heritage Statutory Trust I (formed 2000), Heritage Statutory Trust II (formed 2001) and Heritage Statutory Trust III (formed 2002) (collectively, “Subsidiary Trusts”), which were formed solely to facilitate the issuance of capital trust pass-through securities to enhance regulatory capital and liquidity. Pursuant to FASB Interpretation No. 46, Consolidation of Variable Interest Entities (FIN 46), the Subsidiary Trusts are not reflected on a consolidated basis in the financial statements of the Company.

In June 2007, the Company acquired Diablo Valley Bank. The transaction was valued at approximately $65,400,000, including payments for cancellation of options for Diablo Valley Bank common stock. Diablo Valley Bank shareholders received a per share consideration of $23.00. Accordingly, the Company paid approximately $24,000,000 in cash and issued 1,732,298 shares of the Company’s common stock in exchange for all outstanding Diablo Valley Bank shares and stock options. Prior to closing, Diablo Valley Bank redeemed all of its outstanding Series A Preferred Stock for an aggregate of approximately $6,700,000 in cash (including dividend payments). Two members of the Diablo Valley Bank board of directors, John J. Hounslow and Mark E. Lefanowicz joined the Company’s Board of Directors and James Mayer, President/Diablo Valley Banking Region, joined the Company as

Executive Vice President/East Bay Division.

The Company's principal source of income is dividends from HBC. The expenditures of the Company, including (but not limited to) the payment of dividends to shareholders, if and when declared by the Board of Directors, the cost of servicing debt, legal fees, audit fees, and shareholder costs will generally be paid from dividends paid to the Company by HBC.

At December 31, 2007, the Company had consolidated assets of $1.35 billion, deposits of $1.06 billion and shareholders' equity of $165 million. The Company's liabilities include $24 million in debt obligations due to the Subsidiary Trusts related to capital trust pass-through securities issued by those entities.

The Internet address of the Company's website is "http://www.heritagecommercecorp.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's website.

References herein to the "Company" include the Company and its consolidated subsidiary, unless the context indicates otherwise.

Heritage Bank of Commerce

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 January 1994. HBC is a multi-community independent bank that offers a full range of banking services to small to medium sized businesses and their owners, managers and employees residing in Santa Clara, Alameda, San Mateo, and Contra Costa counties in California. We operate eleven full service branch offices throughout this geographic footprint. The locations of HBC's current offices are:

San Jose:	Administrative Office Main Branch 150 Almaden Boulevard
Los Gatos:	Branch Office 15575 Los Gatos Boulevard
Fremont:	Branch Office 3077 Stevenson Boulevard
Danville:	Branch Office 310 Hartz Avenue
Morgan Hill:	Branch Office 18625 Sutter Boulevard
Gilroy:	Branch Office 7598 Monterey Street
Los Altos:	Branch Office 369 S. San Antonio Road
Los Altos:	Branch Office 4546 El Camino Real
Mountain View:	Branch Office 175 E. El Camino Real
Pleasanton:	Branch Office 300 Main Street

Walnut Creek:	Branch Office 101 Ygnacio Valley Road Ste #100

HBC's gross loan balances at the end of 2007 totaled $1.04 billion. HBC's lending activities are diversified and include commercial, real estate, construction loans, and consumer loans. HBC's commercial loans are made for working capital, financing the purchase of equipment or for other business purposes. Such loans include loans with maturities ranging from thirty days to one year and "term loans," with maturities normally ranging from one to five years. Short-term business loans are generally intended to finance current transactions and typically provide for periodic principal payments, with interest payable monthly. Term loans normally provide for floating or fixed interest rates, with monthly payments of both principal and interest. HBC's commercial loans are centered in locally-oriented commercial activities in markets where HBC has a physical presence through its branch offices and loan production offices.

HBC's real estate term loans consist primarily of loans made based on the borrower's cash flow and are secured by deeds of trust on commercial and residential property to provide a secondary source of repayment. HBC generally restricts real estate term loans to no more than 80% 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 thirty years and a balloon payment due at maturity).

HBC's real estate land and construction loans are primarily short term interim loans to finance the construction of commercial and single family residential properties. 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.

HBC makes consumer loans for the purpose of financing automobiles, various types of consumer goods, and other personal purposes. Additionally, HBC makes home equity lines of credit available to its clientele. Consumer loans generally provide for the monthly payment of principal and interest. Most of HBC's consumer loans are secured by the personal property being purchased or, in the instances of home equity loans or lines, real property.

We also actively engage in Small Business Administration (“SBA”) lending. We have been designated as an SBA Preferred Lender since 1999 and HBC is a participant in the SBA’s innovative “Community Express” program.

As of December 31, 2007, the percentage of our total loans for each of the principal areas in which we directed our lending activities were as follows: (i) commercial 40% (including SBA loans), (ii) real estate secured loans 35%, (iii) construction loans 21%, and (iv) consumer (including home equity) 4%. 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.

In addition to loans, we offer a wide range of deposit products for retail and business banking markets including checking accounts, interest-bearing transaction accounts, savings accounts, time deposits and retirement accounts. We attract deposits from throughout our market area with a customer-oriented product mix, competitive pricing, and convenient locations. At December 31, 2007, we had 15,800 deposit accounts totaling approximately $1.06 billion, including brokered deposits, compared to 13,000 deposit accounts totaling approximately $847 million as of December 31, 2006.

We offer a variety of other products and services to complement our lending and deposit services. These include cashier’s checks, traveler’s checks, bank-by-mail, ATM, night depository, safe deposit boxes, direct deposit, automated payroll services, electronic funds transfers, on-line banking, and other customary banking services. We currently operate 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.

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 and Contra Costa county region, the three counties within which the Company operates, the top three institutions are all multi-billion dollar entities with an aggregate of 159 offices that control a combined 39% of deposit market share based on June 30, 2007 FDIC market share data. HBC ranks thirteenth with 1.59% share of total deposits. These banks have, among other advantages, the ability to finance wide-ranging advertising campaigns and to allocate their resources to regions of highest yield and demand. 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.

In addition to other large regional banks and local community banks, our competitors include savings institutions, securities and brokerage companies, mortgage companies, credit unions, finance 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, mail, personal computer, ATMs, self-service branches, and/or in-store branches. Competitors offering such products include traditional banks and savings associations, credit unions, brokerage firms, asset management groups, finance and insurance companies, internet-based companies, and mortgage banking firms.

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 Financial Modernization Act, effective March 11, 2000 (see "- Regulation and Supervision – Financial Modernization Act"), 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. In those instances where the Company is unable to accommodate a customer's needs, the Company seeks to arrange for such loans on a participation basis with other financial institutions or to have those services provided in whole or in part by its correspondent banks. See Item 1 - "BUSINESS - Supervision and Regulation."

SUPERVISION AND REGULATION

Introduction

Banking is a complex, highly regulated industry. The primary goals of the regulatory scheme are to maintain a safe and sound banking system, protect depositors and the Federal Deposit Insurance Corporation's insurance fund, and facilitate the conduct of sound monetary policy. In furtherance of these goals, Congress and the states have created several largely autonomous regulatory agencies and enacted numerous laws that govern banks, bank holding companies and the financial services industry. Consequently, the growth and earnings performance of the Company and HBC can be affected not only by management decisions and general economic conditions, but also by the requirements of applicable state and federal statues, regulations and the policies of various governmental regulatory authorities, including the Board of Governors of the Federal Reserve System, ("FRB"), and the California Department of Financial Institutions, ("DFI").

The system of supervision and regulation applicable to financial services businesses governs most aspects of the business of the Company and HBC, including: (i) the scope of permissible business; (ii) investments; (iii) reserves that must be maintained against deposits; (iv) capital levels that must be maintained; (v) the nature and amount of collateral that may be taken to secure loans; (vi) the establishment of new branches; (vii) mergers and consolidations with other financial institutions; and (viii) the payment of dividends.

From time to time laws or regulations are enacted which have the effect of increasing the cost of doing business, limiting or expanding the scope of permissible activities, or changing the competitive balance between banks and other financial and non-financial institutions. Proposals to change the laws and regulations governing the operations of banks and bank holding companies are frequently made in Congress, in the California legislature and by various bank and other regulatory agencies. Future changes in the laws, regulations or polices that impact the Company and HBC cannot necessarily be predicted, but they may have a material effect on the business and earnings of the Company and HBC.

The Company

General. The Company's stock is traded on the NASDAQ Global Select Market, and as such the Company is subject to the rules and regulations of The NASDAQ Stock Market, including those related to corporate governance. The Company is also subject to the periodic reporting requirements of Section 13 of the Securities Exchange Act of 1934 (the "Exchange Act") which requires the Company to file annual, quarterly and other current reports with the Securities and Exchange Commission (the "SEC"). The Company 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 the Company'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 the Company promulgated by the SEC under Section 13 of the Exchange Act. As a publicly traded company which had more than $75 million in public float as of June 30, 2007, the Company is classified as an "accelerated filer." In addition to accelerated time frames for filing SEC periodic reports, this also means that the Company is subject to the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 regarding documenting, testing, and attesting to internal controls over financial reporting.

As a bank holding company, the Company is registered under the Bank Holding Company Act of 1956, as amended, or the BHCA, and is subject to regulation by the FRB. Under the BHCA, the Company is subject to periodic examination by the FRB. The Company is also required to file periodic reports of its operations and any additional information regarding its activities and those of its subsidiaries, as may be required by the FRB.

The Company is also a bank holding company within the meaning of Section 3700 of the California Financial Code. Consequently, the Company and HBC are subject to examination by, and may be required to file reports with, the DFI. Regulations have not yet been proposed or adopted or steps otherwise taken to implement the DFI's powers under this statute.

Bank Holding Company Liquidity. The Company is a legal entity, separate and distinct from HBC. The Company has the ability to raise capital on its own behalf or borrow from external sources. The Company may also obtain additional funds from dividends paid by, and fees charged for services provided to, HBC. However, regulatory constraints on HBC may restrict or totally preclude the payment of dividends by HBC to the Company.

The Company is entitled to receive dividends, when and as declared by HBC's Board of Directors. Those dividends may come from funds legally available for those dividends, as specified and limited by the California Financial Code. Under the California Financial Code, funds available for cash dividends by a California-chartered bank are restricted to the lesser of: (i) the bank's retained earnings; or (ii) the bank's net income for its last three fiscal years (less any distributions to shareholders made during such period). With the prior approval of the DFI, cash dividends may also be paid out of the greater of: (a) the bank's retained earnings; (b) net income for the bank's last preceding fiscal year; or (c) net income of the bank's current fiscal year.

If the DFI determines that the shareholders' equity of the bank paying the dividend is not adequate or that the payment of the dividend would be unsafe or unsound for the bank, the DFI may order the bank not to pay the dividend. Since HBC is an FDIC insured institution, it is also possible, depending upon its financial condition and other factors, that the FDIC could assert that the payment of dividends or other payments might, under some circumstances, constitute an unsafe or unsound practice and thereby prohibit such payments.

The Federal Reserve Board has a policy that bank holding companies must serve as a source of financial and managerial strength to their subsidiary banks. It is the Federal Reserve Bank's position that bank holding companies should stand ready to use their available resources to provide adequate capital to their subsidiary banks during periods of financial stress or adversity. Bank holding companies should also maintain the financial flexibility and capital-raising capacity to obtain additional resources for assisting their subsidiary bank.

Transactions with Affiliates. The Company and any subsidiaries it may purchase or organize are deemed to be affiliates of HBC within the meaning of Sections 23A and 23B of the Federal Reserve Act and the FRB's Regulation W. Under Sections 23A and 23B and Regulation W, loans by HBC to affiliates, investments by them in affiliates' stock, and taking affiliates' stock as collateral for loans to any borrower is limited to 10% of HBC's capital, in the case of any one affiliate, and is limited to 20% of HBC's capital, in the case of all affiliates. In addition, transactions between HBC and other affiliates must be on terms and conditions that are consistent with safe and sound banking practices; in particular, a bank and its subsidiaries generally may not purchase from an affiliate a low-quality asset, as defined in the Federal Reserve Act. These restrictions also prevent a bank holding company and its other affiliates from borrowing from a banking subsidiary of the bank holding company, unless the loans are secured by marketable collateral of designated amounts. The Company and HBC are also subject to certain restrictions with respect to engaging in the underwriting, public sale and distribution of securities.

Limitations on Business and Investment Activities. Under the BHCA, a bank holding company must obtain the FRB's approval before: (i) directly or indirectly acquiring more than 5% ownership or control of any voting shares of another bank or bank holding company; (ii) acquiring all or substantially all of the assets of another bank; (iii) or merging or consolidating with another bank holding company.

Bank holding companies may own subsidiaries engaged in certain businesses that the FRB has determined to be "so closely related to banking as to be a proper incident thereto." The Company, therefore, is permitted to engage in a variety of banking-related businesses. Some of the activities that the FRB has determined, pursuant to its Regulation Y, to be related to banking are: (i) making or acquiring loans or other extensions of credit for its own account or for the account of others; (ii) servicing loans and other extensions of credit; (iii) performing functions or activities that may be performed by a trust company in the manner authorized by federal or state law under certain circumstances; (iv) leasing personal and real property or acting as agent, broker, or adviser in leasing such property in accordance with various restrictions imposed by FRB regulations; (v) acting as investment or financial advisor; (vi) providing management consulting advice under certain circumstances; (vii) providing support services, including courier services and printing and selling MICR-encoded items; (viii) acting as a principal, agent, or broker for insurance under certain circumstances; (ix) making equity and debt investments in corporations or projects designed primarily to promote community welfare or jobs for residents; (x) providing financial, banking, or economic data processing and data transmission services; (xi) owning, controlling, or operating a savings association under certain circumstances; (xii) selling money orders, travelers' checks and U.S. Savings Bonds; (xiii) providing securities brokerage services, related securities credit activities pursuant to Regulation T, and other incidental activities; and (xiv) underwriting dealing in obligations of the U.S., general obligations of states and their political subdivisions, and other obligations authorized for state member banks under federal law.

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. Thus, 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 the Company or any subsidiaries; or (iii) the customer must not obtain some other credit, property or services from competitors, except reasonable requirements to assure soundness of credit extended.

The FRB also possesses enforcement powers over bank holding companies and their non-bank subsidiaries to prevent or remedy actions that represent unsafe or unsound practices or violations of applicable statutes and regulations.

Interstate Banking and Branching. The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (the “Interstate Banking Act”) regulates the interstate activities of banks and bank holding companies and establishes a framework for nationwide interstate banking and branching. Since June 1, 1997, a bank has generally been permitted to merge with a bank in another state without the need to obtain explicit state law authorization. However, states were given the ability to prohibit interstate mergers with banks in their own state by “opting-out” (enacting state legislation applying equality to all out-of-state banks prohibiting such mergers) prior to June 1, 1997.

Since 1995, adequately capitalized and managed bank holding companies have been permitted to acquire banks located in any state, subject to two exceptions: first, any state may still prohibit bank holding companies from acquiring a bank which is less than five years old; and second, no interstate acquisition can be consummated by a bank holding companies if the acquirer would control more than 10% of the deposits held by insured depository institutions nationwide or 30% percent or more of the deposits held by insured depository institutions in any state in which the target bank has branches. A bank may establish and operate de novo branches in any state in which the bank does not already maintain a branch if that state has enacted legislation to expressly permit all out-of-state banks to establish branches in that state.

In 1995 California enacted legislation to implement important provisions of the Interstate Banking Act discussed above and to repeal California's previous interstate banking laws, which were largely preempted by the Interstate Banking Act.

The changes effected by Interstate Banking Act and California laws have increased competition in the environment in which the Company operates to the extent that out-of-state financial institutions directly or indirectly enter the Company's market areas. It appears that the Interstate Banking Act has contributed to accelerated consolidation within the banking industry.

Capital Adequacy. Bank holding companies must maintain minimum levels of capital under the FRB's risk-based capital adequacy guidelines. If capital falls below minimum guideline levels, a bank holding company, among other things, may be denied approval to acquire or establish additional banks or non-bank businesses.

The FRB's risk-based capital adequacy guidelines, discussed in more detail below in the section entitled "SUPERVISION AND REGULATION — Heritage Bank of Commerce — Regulatory Capital Guidelines," assign various risk percentages to different categories of assets, and capital is measured as a percentage of risk assets. Under the terms of the guidelines, bank holding companies are expected to meet capital adequacy guidelines based both on total risk assets and on total assets, without regard to risk weights.

The risk-based guidelines are minimum requirements. Higher capital levels will be required if warranted by the particular circumstances or risk profiles of individual organizations. For example, the FRB's capital guidelines contemplate that additional capital may be required to take adequate account of, among other things, interest rate risk, or the risks posed by concentrations of credit, nontraditional activities or securities trading activities. Moreover, any banking organization experiencing or anticipating significant growth or expansion into new activities, particularly under the expanded powers under the Gramm-Leach-Bliley Act, would be expected to maintain capital ratios, including tangible capital positions, well above the minimum levels.

Limitations on Dividend Payments. The California General Corporation Law prohibits the Company from paying dividends on the common stock unless: (i) its retained earnings, immediately prior to the dividend payment, equals or exceeds the amount of the dividend or (ii) immediately after giving effect to the dividend the sum of the Company's assets (exclusive of goodwill and deferred charges) would be at least equal to 125% of its liabilities (not including deferred taxes, deferred income and other deferred liabilities) and the current assets of the Company would be at least equal to its current liabilities, or, if the average of its earnings before taxes on income and before interest expense for the two preceding fiscal years was less than the average of its interest expense for the two preceding fiscal years, at least equal to 125% of its current liabilities. Additionally, the FRB's policy regarding dividends provides that a bank holding company should not pay cash dividends exceeding its net income or which can only be funded in ways that weaken the bank holding company's financial health, such as by borrowing.

The Gramm-Leach-Bliley Act of 1999. On November 12, 1999, the Gramm-Leach-Bliley Act of 1999 (the "Financial Services Modernization Act") was signed into law. The Financial Services Modernization Act is intended to modernize the banking industry by removing barriers to affiliation among banks, insurance companies, the securities industry and other financial service providers. It provides financial organizations with the flexibility to structure such affiliations through a holding company structure or through a financial subsidiary of a bank, subject to certain limitations. The Financial Services Modernization Act establishes a new type of bank holding company, known as a financial holding company, that may engage in an expanded list of activities that are "financial in nature," which include securities and insurance brokerage, securities underwriting, insurance underwriting and merchant banking.

The Company currently meets all the requirements for financial holding company status. However, the Company does not expect to elect financial holding company status unless and until it intends to engage in any of the expanded activities under the Financial Services Modernization Act which require such status. Unless and until it elects such status, the Company will only be permitted to engage in non-banking activities that were permissible for bank holding companies as of the date of the enactment of the Financial Services Modernization Act.

The Financial Services Modernization Act also sets forth a system of functional regulation that makes the FRB the "umbrella supervisor" for holding companies, while providing for the supervision of the holding company's subsidiaries by other federal and state agencies. A bank holding company may not become a financial holding company if any of its subsidiary financial institutions are not well-capitalized or well-managed. Further, each bank subsidiary of the holding company must have received at least a satisfactory Community Reinvestment Financial Services Modernization Act (CRA) rating. The Financial Services Modernization Act also expands the types of financial activities a national bank may conduct through a financial subsidiary, addresses state regulation of insurance, generally prohibits unitary thrift holding companies organized after May 4, 1999 from participating in new financial activities, provides privacy protection for nonpublic customer information of financial institutions, modernizes the Federal Home Loan Bank system and makes miscellaneous regulatory improvements. The FRB and the Secretary of the Treasury must coordinate their supervision regarding approval of new financial activities to be conducted through a financial holding company or through a financial subsidiary of a bank. While the provisions of the Financial Services Modernization Act regarding activities that may be conducted through a financial subsidiary directly apply only to national banks, those provisions indirectly apply to state-chartered banks.

In addition, HBC is subject to other provisions of the Financial Services Modernization Act, including those relating to CRA, privacy and safe-guarding confidential customer information, regardless of whether the Company elects to become a financial holding company or to conduct activities through a financial subsidiary of HBC.

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

The Sarbanes-Oxley Act of 2002. The Sarbanes-Oxley Act of 2002 (“SOX”), became effective on July 30, 2002, and represents the most far reaching corporate and accounting reform legislation since the enactment of the Securities Act of 1933 and the Exchange Act of 1934. SOX is intended to provide a permanent framework that improves the quality of independent audits and accounting services, improves the quality of financial reporting, strengthens the independence of accounting firms and increases the responsibility of management for corporate disclosures and financial statements.

SOX’s provisions are significant to all companies that have a class of securities registered under Section 12 of the Exchange Act, or are otherwise reporting to the SEC (or the appropriate federal banking agency) pursuant to Section 15(d) of the Exchange Act, including the Company (collectively, “public companies”). In addition to SEC rulemaking to implement SOX, The NASDAQ Stock Market has adopted corporate governance rules intended to allow shareholders to more easily and effectively monitor the performance of companies and directors. The principal provisions of SOX provide for and include, among other things: (i) the creation of an independent accounting oversight board; (ii) auditor independence provisions that restrict non-audit services that accountants may provide to their audit clients; (iii) additional corporate governance and responsibility measures, including the requirement that the chief executive officer and chief financial officer of a public company certify financial statements; (iv) the forfeiture of bonuses or other incentive-based compensation and profits from the sale of an issuer’s securities by the chief executive officer and the chief financial officer in the twelve month period following initial publication of any financial statements that later require restatement due to material noncompliance of financial accounting reporting requirements as a result of misconduct; (v) an increase in the oversight of, and enhancement of certain requirements relating to, audit committees of public companies and how they interact with the Company’s independent auditors; (vi) requirements that audit committee members must be independent and are barred from accepting consulting, advisory or other compensatory fees from the issuer; (vii) requirements that companies disclose whether at least one member of the audit committee is a “financial expert’ (as such term is defined by the SEC) and if not, discuss why the audit committee does not have a financial expert; (viii) expanded disclosure requirements for corporate insiders, including accelerated reporting of stock transactions by insiders and a prohibition on insider trading during pension blackout periods; (ix) a prohibition on personal loans to directors and officers, except certain loans made by insured financial institutions on non-preferential terms and in compliance with other bank regulatory requirements; (x) disclosure of a code of ethics and filing a Form 8-K for a change or waiver of such code; (xi) a range of enhanced penalties for fraud and other violations; and (xii) expanded disclosure and certification relating to an issuer’s disclosure controls and procedures and internal controls over financial reporting.

The Company has incurred, and expects to continue to incur, significant time and expense in connection with its compliance with Section 404 of SOX, which requires management to undertake an annual assessment of the adequacy and effectiveness of the Company’s internal control over financial reporting and requires the Company’s auditors to express an opinion on the effectiveness of internal control over financial reporting.

Heritage Bank of Commerce

General. HBC, as a California-chartered bank which is a member of the Federal Reserve System, is subject to regulation, supervision, and regular examination by the DFI and the FRB. HBC’s deposits are insured by the FDIC up to the maximum extent provided by law. The regulations of these agencies govern most aspects of HBC’s business and establish a comprehensive framework governing its operations. California law exempts all banks from usury limitations on interest rates.

The earnings and growth of the Bank are largely dependent on its ability to maintain a favorable differential or “spread” between the yield on its interest-earning assets and the rates paid on its deposits and other interest-bearing liabilities. As a result, the Bank’s performance is influenced by general economic conditions, both domestic and foreign, the monetary and fiscal policies of the federal government, and the policies of the regulatory agencies, particularly the Federal Reserve Board. The Federal Reserve Board implements national monetary policies (such as seeking to curb inflation and combat recession) by means of open-market operations in United States Government securities, adjusting the required level of reserves for financial institutions subject to its reserve requirements, and varying the discount rate applicable to borrowings by banks that are members of the Federal Reserve System. The actions of the Federal Reserve Board in these areas influence the growth of bank loans, investments and deposits and also affect interest rates on loans and deposits. The nature and impact of any future changes in monetary policies cannot be predicted.

Regulatory Capital Guidelines. The federal banking agencies have established minimum capital standards known as risk-based capital guidelines. These guidelines are intended to provide a measure of capital that reflects the degree of risk associated with a bank’s operations. The risk-based capital guidelines include both a definition of capital and a framework for calculating the amount of capital that must be maintained against a bank’s assets and off-balance sheet items. The amount of capital required to be maintained is based upon the credit risks associated with the various types of a bank’s assets and off-balance sheet items. A bank’s assets and off-balance sheet items are classified under several risk categories, with each category assigned a particular risk weighting from 0% to 100%. The following table sets forth the regulatory capital guidelines and the actual capitalization levels for HBC and the Company as of December 31, 2007:

	Adequately Capitalized	Well Capitalized	HBC	Company (consolidated)
	(greater than or equal to)			
Total risked-based capital	8.00%	10.00%	11.76%	12.52%
Tier 1 risk-based capital ratio	4.00%	6.00%	10.74%	11.50%
Tier 1 leverage capital ratio	4.00%	5.00%	10.37%	11.05%

As of December 31, 2007, management believes that the Company's capital levels met all minimum regulatory requirements and that HBC was considered "well capitalized" under the regulatory framework for prompt corrective action.

To enhance regulatory capital and to provide liquidity, the Company, through unconsolidated subsidiary grantor trusts, issued $23.7 million of trust preferred securities. These securities are currently included in our Tier I capital for purposes of determining the Company's Tier I and total risk-based capital ratios. The FRB has promulgated a modification of the capital regulations affecting trust preferred securities. Under this modification, effective March 31, 2009, the Company will be required to use a more restrictive formula to determine the amount of trust preferred securities that can be included in regulatory Tier I capital. At that time, the Company will be allowed to include in Tier I capital an amount of trust preferred securities equal to no more than 25% of the sum of all core capital elements, which is generally defined as shareholders' equity, less accumulated other comprehensive income and goodwill and other intanigble assets, net of any related deferred income tax liability. The regulations currently in effect through December 31, 2008, limit the amount of trust preferred securities that can be included in Tier I capital to 25% of the sum of core capital elements without a deduction for goodwill. Management has determined that the Company's Tier I capital ratios would remain above the "well-capitalized" level had the modification of the capital regulations been in effect at December 31, 2007. Management expects that the Company's Tier I capital ratios will be at or above the existing well capitalized levels on March 31, 2009, the first date on which the modified capital regulations must be applied.

Prompt Corrective Action. The federal banking agencies possess broad powers to take prompt corrective action to resolve the problems of insured banks. Each federal banking agency has issued regulations defining five capital categories: "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized," and "critical undercapitalized." Under the regulations, a bank shall be deemed to be:

- "well capitalized" if it has a total risk-based capital ratio of 10.0% or more, has a Tier 1 risk-based capital ratio of 6.0% or more, has a leverage capital ratio of 5.0% or more, and is not subject to specified requirements to meet and maintain a specific capital level for any capital measure;
- "adequately capitalized" if it has a total risk-based capital ratio of 8.0% or more, a Tier 1 risk-based capital ratio of 4.0% or more, and a leverage capital ratio of 4.0% or more (3.0% under certain circumstances) and does not meet the definition of "well capitalized";
- "undercapitalized" if it has a total risk-based capital ratio that is less than 8.0%, a Tier 1 risk-based capital ratio that is less than 4.0%, or a leverage capital ratio that is less than 4.0% (3.0% under certain circumstances);
- "significantly undercapitalized" if it has a total risk-based capital ratio that is less than 6.0%, a Tier 1 risk-based capital ratio that is less than 3.0% or a leverage capital ratio that is less than 3.0%; and
- "critically undercapitalized" if it has a ratio of tangible equity to total assets that is equal to or less than 2.0%.

Banks are prohibited from paying dividends or management fees to controlling persons or entities if, after making the payment the bank would be "undercapitalized," that is, the bank fails to meet the required minimum level for any relevant capital measure. Asset growth and branching restrictions apply to “undercapitalized” banks. Banks classified as “undercapitalized” are required to submit acceptable capital plans guaranteed by its holding company, if any. Broad regulatory authority was granted with respect to “significantly undercapitalized” banks, including forced mergers, growth restrictions, ordering new elections for directors, forcing divestiture by its holding company, if any, requiring management changes, and prohibiting the payment of bonuses to senior management. Even more severe restrictions are applicable to “critically undercapitalized” banks, those with capital at or less than 2%. Restrictions for these banks include the appointment of a receiver or conservator. All of the federal banking agencies have promulgated substantially similar regulations to implement this system of prompt corrective action.

A bank, based upon its capital levels, that is classified as “well capitalized,” “adequately capitalized” or “undercapitalized” may be treated as though it were in the next lower capital category if the appropriate federal banking agency, after notice and opportunity for a hearing, determines that an unsafe or unsound condition, or an unsafe or unsound practice, warrants such treatment. At each successive lower capital category, an insured bank is subject to more restrictions. The federal banking agencies, however, may not treat an institution as “critically undercapitalized” unless its capital ratios actually warrant such treatment.

In addition to measures taken under the prompt corrective action provisions, insured banks may be subject to potential enforcement actions by the federal banking agencies for unsafe or unsound practices in conducting their businesses or for violations of any law, rule, regulation or any condition imposed in writing by the agency or any written agreement with the agency. Enforcement actions may include the imposition of a conservator or receiver, the issuance of a cease-and-desist order that can be judicially enforced, the termination of insurance of deposits (in the case of a depository institution), the imposition of civil money penalties, the issuance of directives to increase capital, the issuance of formal and informal agreements, the issuance of removal and prohibition orders against institution-affiliated parties. The enforcement of such actions through injunctions or restraining orders may be based upon a judicial determination that the agency would be harmed if such equitable relief was not granted.

The DFI, as the primary regulator for state-chartered banks, also has a broad range of enforcement measures, from cease and desist powers and the imposition of monetary penalties to the ability to take possession of a bank, including causing its liquidation.

Safety and Soundness Standards. The federal banking agencies have also adopted guidelines establishing safety and soundness standards for all insured depository institutions. Those guidelines relate to internal controls, information systems, internal audit systems, loan underwriting and documentation, compensation and interest rate exposure. In general, the standards are designated to assist the federal banking agencies in identifying and addressing problems at insured depository institutions before capital becomes impaired. In an institution fails to meet these standards, the appropriate federal banking agency may require the institution to submit a compliance plan and institute enforcement proceedings if an acceptable compliance plan is not submitted.

FDIC Insurance and Insurance Assessments. Banks and thrifts have historically paid varying amounts of premiums for federal deposit insurance depending upon a risk-based system which evaluated the institution’s regulatory and capital adequacy ratings. The FDIC operated two separate insurance funds, the Bank Insurance Fund (“BIF”) and the Savings Association Insurance Fund (“SAIF”).

As a result of the Federal Deposit Insurance Reform Act of 2005 (the “FDI Reform Act”) and regulations adopted by the FDIC effective as of November 2, 2006: (i) the BIF and the SAIF have been merged into the Deposit Insurance Fund (the “DIF”); (ii) the $100,000 insurance level has been indexed to reflect inflation (the first adjustment for inflation will be effective January 1, 2011 and thereafter adjustments will occur every 5 years); (iii) deposit insurance coverage for retirement accounts has been increased to $250,000, and will also be subject to adjustment every five years; (iv) banks that historically have capitalized the BIF are entitled to a one-time credit which can be used to off-set premiums otherwise due (this addresses the fact that institutions that have grown rapidly have not had to pay deposit premiums); (v) a cap on the level of the DIF has been imposed and dividends will be paid when the DIF grows beyond a specified threshold; and (vi) the previous risk-based system for assessing premiums has been revised.

Prior to January 1, 2007, the FDIC utilized a risk-based assessment system to set semi-annual insurance premium assessments which categorized banks into risk categories based on two criteria, (1) three capital levels and (2) three supervisory ratings, creating a nine-cell matrix for risk-based assessments. The new assessment system consolidates the previous nine risk categories into four and names them Risk Categories I, II, III and IV. The four new categories will continue to be defined based upon supervisory and capital evaluations. In practice, the subgroup evaluations will generally be based on an institution’s composite CAMELS rating assigned to it by the institution’s federal supervisor at the end of its examination. The CAMELS rating system is based upon an evaluation of the five critical elements of an institution’s operations: Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Sensitivity to risk. This rating system is designed to take into account and reflect all significant financial and operational factors financial institution examiners assess in their evaluation of an institution’s performance. The consolidation creates four new Risk Categories as shown in following table:

	Supervisory Subgroup		
Captial Group	A	B	C

1. Well Capitalized	I		
2. Adequately Capitalized		II	III
3. Undercapitalized		III	IV

Within Risk Category I, the new assessment system combines supervisory ratings with other risk measures to differentiate risk. For most institutions, the new assessment system combines CAMELS component ratings with financial ratios to determine an institution's assessment rate. For large institutions that have long-term debt issuer ratings, the new assessment system differentiates risk by combining CAMELS component ratings with those ratings. For large institutions within Risk Category I, initial assessment rate determinations may be modified within limits upon review of additional relevant information. The new assessment system assesses those within Risk Category I that pose the least risk a minimum assessment rate and those that pose the greatest risk a maximum assessment rate that is two basis points higher. An institution that poses an intermediate risk within Risk Category I will be charged a rate between the minimum and maximum that will vary incrementally by institution.

Effective January 1, 2007, the actual assessment rates under this new assessment system are summarized below, expressed in terms of cents per $100 in insured deposits:

Risk Category				
I*				
Minimum	Maximum	II	III	IV
5	7	10	28	43

* Rates for institutions that do no pay the minimum or maximum rate vary between these rates.

The FDIC may terminate its insurance of deposits if it finds that HBC has engaged in unsafe and unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, rule, order or condition imposed by the FDIC.

Money Laundering and Currency Controls. Various federal statutory and regulatory provisions are designed to enhance record-keeping and reporting of currency and foreign transactions. Pursuant to the Bank Secrecy Act, financial institutions must report high levels of currency transactions or face the imposition of civil monetary penalties for reporting violations. The Money Laundering Control Act imposes sanctions, including revocation of federal deposit insurance, for institutions convicted of money laundering.

The International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001 (“IMLAFATA”), a part of the Patriot Act, authorizes the Secretary of the Treasury, in consultation with the heads of other government agencies, to adopt special measures applicable to banks and other financial institutions to enhance record-keeping and reporting requirements for certain financial transactions that are of primary money laundering concern. Among its other provisions, IMLAFATA requires each financial institution to: (i) establish an anti-money laundering program; (ii) establish due diligence policies, procedures and controls with respect to its private banking accounts and correspondent banking accounts involving individuals and certain foreign banks; and (iii) avoid establishing, maintaining, administering, or managing correspondent accounts in the Untied States for, or on behalf of, a foreign bank that does not have a physical presence in any country. In addition, IMLAFATA contains a provision encouraging cooperation among financial institutions, regulatory authorities and law enforcement authorities with respect to individuals, entities and organizations engaged in, or reasonably suspected of engaging in, terrorist acts or money laundering activities.

The Treasury Department’s regulations implementing IMLAFATA mandate that federally-insured banks and other financial institutions establish customer identification programs designed to verify the identity of persons opening new accounts, maintain the records used for verification, and determine whether the person appears on any list of known or suspected terrorists or terrorist organizations.

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

The federal banking agencies have adopted regulations which measure a bank’s compliance with its CRA obligations on a performance-based evaluation system. 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.

Other Consumer Protection Laws and Regulations. The bank regulatory agencies are increasingly focusing attention on compliance with consumer protection laws and regulations. Banks have been advised to carefully monitor compliance with various consumer protection laws and regulations. The federal Interagency Task Force on Fair Lending issued a policy statement on discrimination in home mortgage lending describing three methods that federal agencies will use to prove discrimination: overt evidence of discrimination, evidence of disparate treatment, and evidence of disparate impact. In addition to CRA and fair lending requirements, HBC is subject to numerous other federal consumer protection statutes and regulations. Due to heightened regulatory concern related to compliance with consumer protection laws and regulations generally, HBC may incur additional compliance costs or be required to expend additional funds for investments in the local communities it serves.

Environmental Regulation. Federal, state and local laws and regulations regarding the discharge of harmful materials into the environment may have an impact on HBC. Since HBC is not involved in any business that manufactures, uses or transports chemicals, waste, pollutants or toxins that might have a material adverse effect on the environment, HBC’s primary exposure to environmental laws is through its lending activities and through properties or businesses HBC may own, lease or acquire. Based on a general survey of HBC’s loan portfolio, conversations with local appraisers and the type of lending currently and historically done by HBC, management is not aware of any potential liability for hazardous waste contamination that would be reasonably likely to have a material adverse effect on the Company as of December 31, 2007.

Safeguarding of Customer Information and Privacy. The FRB and other bank regulatory agencies have adopted guidelines for safeguarding confidential, personal customer information. These guidelines require financial institutions to create, implement and maintain a comprehensive written information security program designed to ensure the security and confidentiality of customer information, protect against any anticipated threats or hazards to the security or integrity of such information and protect against unauthorized access to or use of such information that could result in substantial harm or inconvenience to any customer. HBC has adopted a customer information security program to comply with such requirements.

Financial institutions are also required to implement policies and procedures regarding the disclosure of nonpublic personal information about consumers to non-affiliated third parties. In general, financial institutions must provide explanations to consumers on policies and procedures regarding the disclosure of such nonpublic personal information, and, except as otherwise required by law, prohibits disclosing such information except as provided in HBC's policies and procedures. HBC has implemented privacy policies addressing these restrictions which are distributed regularly to all existing and new customers of HBC.

USA Patriot Act of 2001. On October 26, 2001, President Bush signed the USA Patriot Act of 2001 (the "Patriot Act"). Enacted in response to the terrorist attacks in New York, Pennsylvania and Washington, D.C. on September 11, 2001, the Patriot Act is intended to strengthen the ability of U.S. law enforcement agencies and intelligence communities to work cohesively to combat terrorism on a variety of fronts. The impact of the Patriot Act on financial institutions of all kinds has been significant and wide ranging. The Patriot Act substantially enhanced existing anti-money laundering and financial transparency laws, and required appropriate regulatory authorities to adopt rules to promote cooperation among financial institutions, regulators, and law enforcement entities in identifying parties that may be involved in terrorism or money laundering. Under the Patriot Act, financial institutions are subject to prohibitions regarding specified financial transactions and account relationships, as well as enhanced due diligence and "know your customer" standards in their dealings with foreign financial institutions and foreign customers. For example, the enhanced due diligence policies, procedures, and controls generally require financial institutions to take reasonable steps:

- to conduct enhanced scrutiny of account relationships to guard against money laundering and report any suspicious transactions;

- to ascertain the identity of the nominal and beneficial owners of, and the source of funds deposited into, each account as needed to guard against money laundering and report any suspicious transactions;

- to ascertain for any foreign bank, the shares of which are not publicly traded, the identity of the owners of the foreign bank, and the nature and extent of the ownership interest of each such owner; and

- to ascertain whether any foreign bank provides correspondent accounts to other foreign banks and, if so, the identity of those foreign banks and related due diligence information.

The Patriot Act also requires all financial institutions to establish anti money laundering programs, which must include, at minimum:

- the development of internal policies, procedures, and controls;

- the designation of a compliance officer;

- an ongoing employee training program; and

- an independent audit function to test the programs.

HBC has incorporated the requirements of the Patriot Act into its operating procedures, and while these requirements have resulted in an additional time burden the financial impact on HBC is difficult to quantify.

Other Aspects of Banking Law. HBC is also subject to federal statutory and regulatory provisions covering, among other things, security procedures, insider and affiliated party transactions, management interlocks, electronic funds transfers, funds availability, and truth-in-savings.

Other Pending and Proposed Legislation

Other legislative and regulatory initiatives which could affect the Company, HBC and the banking industry in general are pending, and additional initiatives may be proposed or introduced before the United States Congress, the California legislature and other governmental bodies in the future. Such proposals, if enacted, may further alter the structure, regulation and competitive relationship among financial institutions, and may subject the Company or HBC to increased regulation, disclosure and reporting requirements. 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.

EMPLOYEES

At December 31, 2007, the Company had 225 full-time equivalent employees. The Company’s employees are not represented by any union or collective bargaining agreement and the Company believes its employee relations are satisfactory.

ITEM 1A – RISK FACTORS

In addition to the other information in this Annual Report on Form 10-K, shareholders or prospective investors should carefully consider the following risk factors:

Our profitability is dependent upon the economic conditions of the markets in which we operate. We operate primarily in Santa Clara County, Contra Costa County and Alameda County and, as a result, our financial condition, results of operations and cash flows are subject to changes in the economic conditions in those areas. Our success depends upon the business activity, population, income levels, deposits and real estate activity in these markets. Although our customers' business and financial interests may extend well beyond these market areas, adverse economic conditions that affect these market areas could reduce our growth rate, affect the ability of our customers to repay their loans to us and generally affect our financial condition and results of operations. 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. Thus, the Company's borrowers could be adversely impacted by a downturn in these sectors of the economy which could reduce the demand for loans and adversely impact the borrower's ability to repay their loans. Because of our geographic concentration, we are less able than other regional or national financial institutions to diversify our credit risks across multiple markets.

Our growth must be effectively managed and our growth strategy involves risks that may impact our net income. As part of our general growth strategy, we may expand into additional communities or attempt to strengthen our position in our current markets to take advantage of expanding market share by opening new offices. To the extent that we undertake additional office openings, 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 may have an adverse effect on our levels of reported net income, return on average equity and return on average assets. Our current growth strategies involve internal growth from our current offices and the addition of new branch offices over time, so that the additional overhead expenses associated with these openings is absorbed prior to opening other new offices.

We must compete with other banks and financial institutions in all lines of business. The banking and financial services business in our market is highly competitive. Our competitors include large regional banks, local community banks, savings institutions, securities and brokerage companies, mortgage companies, insurance companies, finance companies, money market mutual funds, credit unions and other non-bank financial service providers. Many of these competitors are not subject to the same regulatory restrictions we are and are able to provide customers with an alternative to traditional banking services. In addition, there is an increased importance on remaining current on technological changes because such technological advances may diminish the importance of depository institutions and financial intermediaries in the transfer of funds between parties. Increased competition in our market and market changes, such as interest rate changes, force management to better control costs in order to absorb any resultant narrowing of our net interest margin, i.e., the spread between the interest rates earned on investments and loans and the interest rates paid on deposits and other interest-bearing liabilities. Without effective management and cost controls, net income may be adversely impacted by changing conditions and competition.

Interest rates and other conditions impact our results of operations. The earnings of most financial institutions depend largely on the relationship between the cost of funds, primarily deposits and borrowings, and the yield on earning assets such as loans and investment securities. This relationship, known as the interest rate spread, is subject to fluctuation and is affected by economic, regulatory and competitive factors that influence interest rates, the volume and mix of interest-earning assets and interest-bearing liabilities, and the level of non-performing assets. Many of these factors are beyond our control. Fluctuations in interest rates affect the demand of customers for our products and services, and we are subject to interest rate risk to the degree that our interest-bearing liabilities re-price or mature more slowly or more rapidly or on a different basis than our interest-earning assets. Given the current volume, mix, and re-pricing characteristics of our interest-bearing liabilities and interest-earning assets, our interest rate spread is expected to increase slightly in a rising rate environment, and decrease slightly in a declining interest rate scenario. However, there are scenarios where fluctuations in interest rates in either direction could have a negative effect on net income. For example, if funding rates rise faster than asset yields in a rising rate environment (i.e., if basis compression occurs), or if we do not actively manage certain loan index rates in a declining rate environment, we would be negatively impacted.

We must effectively manage our credit risk. There are risks inherent in making any loan, including risks inherent in dealing with individual borrowers, risks of nonpayment, risks resulting from uncertainties as to the future value of collateral and risks resulting from changes in economic and industry conditions. We attempt to minimize our credit risk through prudent loan application approval procedures, careful monitoring of the concentration of our loans within specific industries and periodic independent reviews of outstanding loans by external parties. However, we cannot assure such approval and monitoring procedures will eliminate these credit risks.

Our allowance for loan losses must be managed to provide a sufficient amount to absorb probable incurred losses in our loan portfolio. We maintain our allowance for loan losses at a level considered adequate by management to absorb probable incurred loan losses. The amount of future loan losses is susceptible to changes in economic, operating and other conditions within our market, which may be beyond our control, and such losses may exceed current estimates. At December 31, 2007, our allowance for loan losses as a percentage of total loans was 1.18%. Although management believes that the allowance for loan losses is adequate to absorb probable incurred losses on existing loans, we cannot predict loan losses with certainty, and we cannot assure that our allowance for loan losses will prove sufficient to cover actual loan losses in the future. Loan losses in excess of our allowance may adversely affect our business, financial condition and results of operations. Additional information regarding our allowance for loan losses and the methodology we use to determine an appropriate level of the allowance is located in the "Management's Discussion and Analysis of Financial Condition and Operations" section included under Item 7 of Part II of this Form 10-K.

Government regulation can result in limitations on our operations. We operate in a highly regulated environment and are subject to supervision and regulation by a number of governmental regulatory agencies, including the Board of Governors of the Federal Reserve System, the California Department of Financial Institutions and the Federal Deposit Insurance Corporation. 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 and profitability. Increased regulation could increase our cost of compliance and adversely affect profitability.

Technology is continually changing and we must effectively implement new technologies. 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 us 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 areas. In order to anticipate and develop new technology, we employ a qualified staff of internal information system specialists and consider this area a core part of our business. We do not develop our own software products, but have been able to respond to technological changes in a timely manner through association with leading technology vendors. We must continue to make substantial investments in technology which may affect our net income.

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 unforeseen problems. Our operations are dependent upon our ability to protect our computer equipment against damage from physical theft, fire, power loss, telecommunications failure or a similar catastrophic event, as well as from security breaches, denial of service attacks, viruses, worms and other disruptive problems caused by hackers. Any damage or failure that causes an interruption in our operations could have a material adverse effect on our financial condition and results of operations. Computer break-ins and other disruptions could also jeopardize the security of information stored in and transmitted through our computer systems and network infrastructure, which may result in significant liability to us and may cause existing and potential customers to refrain from doing business with us. On an outsourced basis, we engage auditors to conduct extensive auditing and testing for any weaknesses in our systems, controls, firewalls and encryption to reduce the likelihood of any security failures or breaches. Although we, with the help of third-party service providers and auditors, intend to continue to implement security technology and establish operational procedures to prevent such damage, there can be no assurance that these security measures will be successful. In addition, advances in computer capabilities, new discoveries in the field of cryptography or other developments could result in a compromise or breach of the algorithms we and our third-party service providers use to encrypt and protect customer transaction data. A failure of such security measures could have a material adverse affect on our financial condition and results of operations.

Our loan portfolio has a large concentration of real estate loans, which involve risks specific to real estate value. Real estate lending (including commercial and construction) is a large portion of our loan portfolio; however, it is within recently established regulatory guidelines based on a percentage of Tier 2 Capital. These categories constitute $621 million, or approximately 60% of our total loan portfolio as of December 31, 2007. 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. Although a significant portion of such loans is secured by real estate as a secondary form of collateral, adverse developments affecting real estate values in one or more of our markets could increase the credit risk associated with our loan portfolio. Commercial and residential properties have recently experienced a decrease in market value. Commercial real estate lending typically involves larger loan principal amounts and the repayment of the loans generally is dependent, in large part, on sufficient income from the properties securing the loans to cover operating expenses and debt service. Economic events or governmental regulations outside of the control of the borrower or lender could negatively impact the future cash flow and market values of the affected properties. If the loans that are collateralized by real estate become troubled during a time when market conditions are declining or have declined, we may not be able to realize the amount of security that we anticipated at the time of originating the loan, which could cause us to increase our provision for loan losses and adversely affect our operating results and financial condition.

Our construction and 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, 2007, residential construction loans, including land acquisition and development, totaled $216 million or 21%, of our total loan portfolio. Of the $216 million, $157 million was construction loans comprised of $92 million residential and $65 million commercial. The other $59 million of construction loans represent land loans consisting of $46 million residential and $13 million commercial. Construction, land acquisition and development lending involve additional risks because funds are advanced upon the security of the project, which is of uncertain value prior to its completion. Because of the uncertainties inherent in estimating construction costs, as well as the market value of the completed project and the effects of governmental regulation on real property, it is relatively difficult to evaluate accurately the total funds required to complete a project and the related loan-to-value ratio. This process has become more difficult as commercial and residential properties have recently experienced decreases in market value. As a result, speculative construction loans often involve the disbursement of substantial funds with repayment dependent, in part, on the completion of the project and the ability of the borrower to sell 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, we may have inadequate security for the repayment of the loan upon completion of construction of the project. If we are forced to foreclose on a project prior to or at completion due to a default, there can be no assurance that we will 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.

Acquisition risks. We have in the past and may in the future seek to grow our business by acquiring other businesses. We cannot predict the frequency, size or timing of our acquisitions, and we typically do not comment publicly on a possible acquisition until we have signed a definitive agreement. There can be no assurance that our acquisitions will have the anticipated positive results, including results related to: the total cost of integration; the time required to complete the integration; the amount of longer-term cost savings; continued growth; or the overall performance of the acquired company or combined entity. Integration of an acquired business can be complex and costly. If we are not able to integrate successfully past or future acquisitions, there is a risk that results of operations could be adversely affected.

Impairment of goodwill or amortizable intangible assets associated with acquisitions would result in a charge to earnings. Goodwill is evaluated for impairment at least annually, and amortizable intangible assets are evaluated for impairment annually or when events or circumstances indicate that the carrying value of those assets may not be recoverable. We may be required to record a charge to the earnings during the period in which any impairment of goodwill or intangibles is determined.

ITEM 1B – UNRESOLVED STAFF COMMENTS

None

ITEM 2 – PROPERTIES

The main and executive offices of the Company and Heritage Bank of Commerce 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 387 Diablo Road in Danville, California 94526, at 3077 Stevenson Boulevard in Fremont, California 94538, at 300 Main Street in Pleasanton, California 94566, at 101 Ygnacio Valley Road in Walnut Creek, California 94596, at 18625 Sutter Boulevard in Morgan Hill, California 95037, at 7598 Monterey Street in Gilroy, California 95020, at 4546 El Camino Real in Los Altos, California 94022, at 369 S. San Antonio Road in Los Altos, California 94022, and at 175 E. El Camino Real in Mountain View, California 94040.

Main Offices

The main offices of Heritage Bank of Commerce are located at 150 Almaden Boulevard in San Jose, California on the first three floors in a fifteen-story Class-A type office building. The first two floors, which consist of approximately 22,417 square feet, were subleased from a non-affiliated third party under a lease dated February 12, 1996, as amended. The third floor, which consists of approximately 12,824 square feet, was acquired directly under a lease dated April 13, 2000, as amended. The current monthly rent payment for the third floor is $28,726 and is subject to annual increases of 3% until August 1, 2009, when the monthly rent payment will become fixed at $53,861 until the lease expires on May 31, 2015. The current monthly rent payment for the first two floors is $42,592 until the sublease expires on February 28, 2010; however, after the sublease expires, the first two floors will become part of the direct lease for the third floor, subject to all of the terms and conditions therein, except that the monthly rent will be based on the then prevailing market rate to be determined no later than January 15, 2010. The Company has reserved the right to extend the term of the direct lease for two additional periods of five years each.

In January of 1997, the Company leased 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 $2,811 and is subject to annual increases of 3% until August 1, 2009 when the monthly rent payment will then become fixed at $5,271 until the lease expires on May 31, 2015. The Company has reserved the right to extend the term of the lease for two additional periods of five years each.

Branch Offices

In March of 1999, the Company leased approximately 7,260 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 $11,944 and is subject to adjustment every 36 months, based on the Consumer Price Index of the Labor of Statistics as defined in the lease agreement, until the lease expires on October 31, 2014.

In October of 2000, as part of a merger the Company assumed a lease for approximately 7,889 square feet in a two-story multi-tenant shopping center located at 4546 El Camino Real in Los Altos, California. In October of 2001, the lease was amended to return 795 square feet, leaving 7,094 square feet remaining under the lease. The current monthly rent payment is $16,550 until the lease expires on September 30, 2008.

In October of 2000, as part of a merger the Company assumed a lease for approximately 3,471 square feet in a one-story stand-alone office building located at 369 S. San Antonio Road in Los Altos, California. The current monthly rent payment is $17,291 until the lease expires on September 30, 2008. The Company has reserved the right to extend the term of the lease for two additional periods of five years each.

In December of 2003, the Company leased 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 $4,930 until the lease expires on November 30, 2008. The Company has reserved the right to extend the term of the lease for two additional periods of five years each.

In May of 2006, the Company leased 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 $4,509 and is subject to annual increases of 2% until the lease expires on September 30, 2016. However, as provided for in the lease, the monthly rent payment has been waived until January of 2009 in exchange for a tenant improvement allowance equal to the amount that would have been paid during the free rent period. The Company has reserved the right to extend the term of the lease for two additional periods of five years each.

In April of 2007, the Company leased approximately 3,850 square feet in a four-story multi-tenant office building located at 101 Ygnacio Valley Road in Walnut Creek, California. The current monthly rent payment is $12,705 and is subject to annual increases of 3% until the lease expires on August 15, 2014. The Company has reserved the right to extend the term of the lease for an additional five years.

In June of 2007, as part of the acquisition of Diablo Valley Bank the Company took ownership of an 8,300 square foot one-story commercial building, including the land, located at 387 Diablo Road in Danville, California. The Company also assumed a lease for approximately 4,096 square feet in a stand-alone office building located at 300 Main Street in Pleasanton, California. The current monthly rent payment is $14,983 and is subject to annual increases of 3% until the lease expires on October 31, 2010. The Company has reserved the right to extend the term of the lease for one additional period of seven years.

In August of 2007, the Company extended its lease for approximately 6,590 square feet in a stand-alone office building located at 3077 Stevenson Boulevard in Fremont, California. The current monthly rent payment is $13,180 and is subject to annual increases of 3% until the lease expires on February 28, 2013. The Company has reserved the right to extend the term of the lease for one additional period of five years.

In February 2008, the Company extended its lease for approximately 4,840 square feet in a multi-tenant shopping center located at 175 E. El Camino Real in Mountain View, California. The current monthly rent payment is $13,986 and is subject to annual increases based on the Consumer Price Index of the Bureau of Labor Statistics as defined in the lease agreement. The lease expires on May 30, 2013; however, the Company has reserved the right to extend the term of the lease for one additional period of five years.

Loan Production Offices

In October of 2007, the Company lease approximately 250 square feet of office space for a loan production office located at 740 Fourth Street in Santa Rosa, California 95404. The current monthly rent payment is $1,250 until the lease expires on October 7, 2008.

In November of 2007, the Company lease approximately 243 square feet of office space for a loan production office located at 1440 Broadway in Oakland, California 94612. The current monthly rent payment is $535 until the lease expires on November 18, 2008.

In January of 2008, the Company extended its lease for approximately 225 square feet of office space for a loan production office located at 8788 Elk Grove Boulevard in Elk Grove, California 95624. The current monthly rent payment for this space is $702 until the lease expires on January 31, 2009. The Company has reserved the right to extend the term of the lease for one additional period of one year.

In February of 2008, the Company renewed its lease for a loan production office located at 264 Clovis Avenue in Clovis, California 93612. The lease covers approximately 140 square feet of office space and expires on March 31, 2009. The current monthly rent payment for this space is $500.

For additional information on operating leases and rent expense, refer to Footnote 11 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.

ITEM 4 - SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

There was no submission of matters to a vote of security holders during the fourth quarter of the year ended December 31, 2007.

PART II

ITEM 5 - MARKET FOR 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." Management is aware of the following securities dealers which make a market in the Company's common stock: Citigroup Global Markets Holdings Inc., Keefe, Brunette & Woods, Inc., Knight Equity Markets, L.P., Merrill Lynch, Morgan Stanley & Company, Inc., RBC Dain Rauscher Inc., UBS Capital Markets, Goldman Sachs & Co., Citadel Derivatives Markets, Howe Barnes Hoefer & Arnett, and E-Trade Capital Markets. These market makers have committed to make a market for the Company's common stock, although they may discontinue making a market at any time. No assurance can be given that an active trading market will be sustained for the common stock at any time in the future.

The information in the following table for 2007 and 2006 indicates the high and low closing prices for the common stock, based upon information provided by the NASDAQ Global Select Market.

Quarter	High	Low	Dividends Paid Per Share
Year ended December 31, 2007:			
Fourth quarter	$ 21.97	$ 15.45	$ 0.08
Third quarter	$ 24.47	$ 18.55	$ 0.06
Second quarter	$ 25.54	$ 21.72	$ 0.06
First quarter	$ 27.34	$ 24.68	$ 0.06
Year ended December 31, 2006:			
Fourth quarter	$ 27.25	$ 22.61	$ 0.05
Third quarter	$ 24.95	$ 22.55	$ 0.05
Second quarter	$ 25.16	$ 22.30	$ 0.05
First quarter	$ 25.00	$ 21.08	$ 0.05

As of February 15, 2008, there were approximately 2,500 holders of record of common stock. There are no other classes of common equity outstanding.

Dividends

As a bank holding company that currently has no significant assets other than its equity interest in HBC, the Company's ability to declare dividends depends primarily upon dividends it receives from HBC. HBC's dividend practices in turn depend upon legal restrictions, HBC's earnings, financial position, current and anticipated capital requirements, and other factors deemed relevant by HBC's Board of Directors at that time.

The Company declared a $0.08 per share quarterly cash dividend on January 30, 2008. The dividend will be paid on March 19, 2008, to shareholders of record on February 27, 2008.

The Company paid cash dividends totaling $3.25 million, or $0.26 per share in 2007 representing 23% of 2007 earnings. The Company's general dividend policy is to pay cash dividends within the range of typical peer payout ratios, provided that such payments do not adversely affect the Company's financial condition and are not overly restrictive to our growth capacity. However, no assurance can be given that earnings and/or growth expectations in any given year will justify the payment of such a dividend.

During any period in which the Company has deferred payment of interest otherwise due and payable on its subordinated debt securities, it may not make any dividends or distributions with respect to its capital stock (see "Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations – Capital Resources"). The ability of HBC's Board of Directors to declare cash dividends is also subject to statutory and regulatory restrictions which limit the amount available for cash dividends depending upon the earnings, financial condition and cash needs of HBC, as well as general business conditions. Under California banking law, HBC may declare dividends in an amount not exceeding the lesser of its retained earnings or its net income for the last three years (reduced by dividends paid during such period) or, with the prior approval of the California Commissioner of Financial Institutions, in an amount not exceeding the greatest of (i) the retained earnings of HBC, (ii) the net income of HBC for its last fiscal year, or (iii) the net income of HBC for its current fiscal year. The payment of any cash dividends by HBC will depend not only upon HBC's earnings during a specified period, but also on HBC meeting certain regulatory capital requirements.

The Company's ability to pay dividends is also limited by state corporation law. The California General Corporation Law prohibits the Company from paying dividends on the Common Stock unless: (i) its retained earnings, immediately prior to the dividend payment, equals or exceeds the amount of the dividend or (ii) immediately after giving effect to the dividend the sum of the Company's assets (exclusive of goodwill and deferred charges) would be at least equal to 125% of its liabilities (not including deferred taxes, deferred income and other deferred liabilities) and the current assets of the Company would be at least equal to its current liabilities, or, if the average of its earnings before taxes on income and before interest expense for the two preceding fiscal years was less than the average of its interest expense for the two preceding fiscal years, at least equal to 125% of its current liabilities.

Additionally, the FRB's policy regarding dividends provides that a bank holding company should not pay cash dividends exceeding its net income or which can only be funded in ways that weaken the bank holding company's financial health, such as by borrowing.

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

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

Performance Graph

The following graph compares the stock performance of the Company from December 31, 2002 to December 31, 2007, 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, 2002 to December 31, 2007, 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	12/31/02	12/31/03	12/31/04	12/31/05	12/31/06	12/31/07
Heritage Commerce Corp *	100	142	220	249	308	213
S&P 500 *	100	126	138	142	161	167
NASDAQ - Total US*	100	150	163	165	181	199
NASDAQ Bank Index*	100	130	144	138	153	119

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

Stock Repurchase Program

In July 2007, the Company's Board of Directors authorized the purchase of up to $30 million of its common stock, which represents approximately 1.48 million shares, or 11%, of its outstanding shares at the current market price on the date of authorization. The share repurchase authorization is valid through July, 2009. The Company intends to continue to finance the repurchase of shares using its available cash. Shares may be repurchased by the Company in open market purchases or in privately negotiated transactions as permitted under applicable rules and regulations. The repurchase program may be modified, suspended or terminated by the Board of Directors at any time without notice. The extent to which the Company repurchases its shares and the timing of such repurchases will depend upon market conditions and other corporate considerations.

The following table provides information concerning the Company's repurchase of its common stock during the fourth quarter of 2007, which were all executed in accordance with SEC Rule 10b-18 in 2007.

	October	November	December
Total Shares Purchased	-	196,216	162,274
Average Per Share Price	$ -	$ 16.57	$ 18.02
Number of Shares as Part of Announced Plan or Program	-	196,216	162,274
Maximum Amount Remaining for Purchase Under Plan or Program	$ 24,021,440	$ 20,769,336	$ 17,844,363

Securities Authorized for Issuance Under Equity Compensation Plan

The information concerning our equity compensation plans is incorporated by reference herein to the section of the proxy statement entitled "Equity Compensation and Plan Information."

ITEM 6 - SELECTED FINANCIAL DATA

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

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SELECTED FINANCIAL DATA

	AT OR FOR YEAR ENDED DECEMBER 31,				
(Dollars in thousands, except per share amounts and ratios)	2007	2006	2005	2004	2003
INCOME STATEMENT DATA:					
Interest income	$ 78,712	$ 72,957	$ 63,756	$ 50,685	$ 46,447
Interest expense	27,012	22,525	15,907	9,648	10,003
Net interest income before provision for loan losses	51,700	50,432	47,849	41,037	36,444
Provision for loan losses	(11)	(503)	313	666	2,900
Net interest income after provision for loan losses	51,711	50,935	47,536	40,371	33,544
Noninterest income	8,052	9,840	9,423	10,544	10,812
Noninterest expense	37,530	34,268	35,233	39,238	33,084
Income before income taxes	22,233	26,507	21,726	11,677	11,272
Income tax expense	8,137	9,237	7,280	3,199	3,496
Net income	$ 14,096	$ 17,270	$ 14,446	$ 8,478	$ 7,776
PER SHARE DATA:					
Basic net income (1)	$ 1.14	$ 1.47	$ 1.22	$ 0.73	$ 0.69
Diluted net income (2)	$ 1.12	$ 1.44	$ 1.19	$ 0.71	$ 0.67
Book value (3)	$ 12.90	$ 10.54	$ 9.45	$ 8.45	$ 7.86
Tangible book value per share	$ 9.20	$ 10.54	$ 9.45	$ 8.45	$ 7.86
Weighted average number of shares outstanding - basic	12,398,270	11,725,671	11,795,635	11,559,155	11,221,232
Weighted average number of shares outstanding - diluted	12,536,740	11,956,433	12,107,230	11,986,856	11,572,588
Shares outstanding at period end	12,774,926	11,656,943	11,807,649	11,669,837	11,381,037
BALANCE SHEET DATA:					
Securities	$ 135,402	$ 172,298	$ 198,495	$ 232,809	$ 153,473
Net loans	$ 1,024,247	$ 699,957	$ 669,901	$ 708,611	$ 636,221
Allowance for loan losses	$ 12,218	$ 9,279	$ 10,224	$ 12,497	$ 13,451
Goodwill and other intangible assets	$ 48,153	$ -	$ -	$ -	$ -
Total assets	$ 1,347,472	$ 1,037,138	$ 1,130,509	$ 1,108,173	$ 1,005,982
Total deposits	$ 1,064,226	$ 846,593	$ 939,759	$ 918,535	$ 835,410
Securities sold under agreement to repurchase	$ 10,900	$ 21,800	$ 32,700	$ 47,800	$ 43,600
Short-term borrowings	$ 60,000	$ -	$ -	$ -	$ -
Notes payable to subsidiary grantor trusts	$ 23,702	$ 23,702	$ 23,702	$ 23,702	$ 23,702
Total shareholders' equity	$ 164,824	$ 122,820	$ 111,617	$ 98,579	$ 89,485

SELECTED PERFORMANCE RATIOS: (4)

Return on average assets	1.18%	1.57%	1.27%	0.80%	0.81%
Return on average tangible assets	1.21%	1.57%	1.27%	0.80%	0.81%
Return on average equity	9.47%	14.62%	13.73%	9.04%	9.04%
Return on average tangible equity	11.43%	14.62%	13.73%	9.04%	9.04%
Net interest margin	4.86%	5.06%	4.58%	4.22%	4.15%
Efficiency ratio	62.81%	56.86%	61.52%	76.07%	70.01%
Average net loans (excludes loans held for sale) as a percentage of average deposits	84.06%	77.61%	73.55%	77.11%	77.21%
Average total shareholders' equity as a percentage of average total assets	12.47%	10.75%	9.25%	8.80%	8.95%
SELECTED ASSET QUALITY RATIOS:					
Net loan charge-offs (recoveries) to average loans	(0.10)%	0.06%	0.28%	0.19%	0.41%
Allowance for loan losses to total loans	1.18%	1.31%	1.51%	1.73%	2.03%
CAPITAL RATIOS:					
Tier 1 risk-based	11.5%	17.3%	14.2%	13.0%	13.3%
Total risk-based	12.5%	18.4%	15.3%	14.3%	14.5%
Leverage	11.1%	13.6%	11.6%	10.9%	11.1%

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Notes:

1) Represents net income divided by the average number of shares of common stock outstanding for the respective period.

2) Represents net income divided by the average number of shares of common stock and common stock-equivalents outstanding for the respective period.

3) Represents shareholders' equity divided by the number of shares of common stock outstanding at the end of the period indicated.

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

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

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 with its own performance objectives established in the internal planning process.

The primary activity of the Company is commercial banking. The Company's operations are located entirely in the southern and eastern regions of the general San Francisco Bay area of California in the counties of Santa Clara, Alameda and Contra Costa. The largest city in this area is San Jose and the Company's market includes the headquarters of a number of technology based companies in the region known commonly as Silicon Valley. The Company's customers are primarily closely held businesses and professionals.

Performance Overview

Net income in 2007 was $14.1 million, a decrease of $3.2 million, or 18%, compared to $17.3 million in 2006. Net income in 2006 was $2.8 million higher than 2005 net income of $14.4 million. Net income per diluted share was $1.12 for 2007, as compared to $1.44 during 2006 and $1.19 in 2005. The Company's Return on Average Assets was 1.18% and Return on Average Equity was 9.47% in 2007, as compared to 1.57% and 14.62%, respectively for 2006, and 1.27% and 13.73%, respectively in 2005. The Company's return on average tangible assets and return on average tangible equity were 1.21% and 11.43%, respectively, for 2007, compared to 1.57% and 14.62%, respectively, for 2006, and 1.27% and 13.73%, respectively, for 2005.

The following are major factors impacting the Company's results of operations in recent years:

- Net interest income increased by $1.3 million, or 3%, in 2007, and by $3.4 million, or 7%, in 2006. The growth in 2007 was largely driven by an increase in average interest earning assets and the growth in 2006 was largely driven by an increased rate on earning assets.

- Noninterest income decreased by 18% in 2007 from 2006. The Company's changed its strategy regarding its SBA loan business. The Company is now retaining most of its SBA production in lieu of selling loans. The Company's noninterest income declined in 2007 as a result of the change in strategy.

- The efficiency ratio was 62.81% in 2007, compared to 56.86% in 2006 and 61.52% in 2005. The higher efficiency ratio in 2007 reflects the additional senior level bankers and a new SBA team the Company hired during 2007 and costs associated with the acquisition of Diablo Valley Bank.

- Noninterest expense increased to $37.5 million in 2007, compared to $34.3 million in 2006 and $35.2 million in 2005. Charges relative to the Diablo Valley Bank acquisition accounted for $1.3 million of the increase, including $352,000 for intangible asset amortization, $400,000 of consulting agreement expense, $40,000 of non-compete agreement expense, and compensation expense of $461,000 for employees who are no longer with the Company. Compensation expense increased 9% in 2007 compared to a year ago. The increase in compensation expense was primarily due to the merger with Diablo Valley Bank, the addition of senior level bankers and hiring of a new SBA team during 2007. Up front costs associated with the hiring of new bankers for the East Bay expansion and SBA team totaled $970,000 in 2007.

- A credit provision for loan losses of $11,000 was recorded in 2007, compared to a credit provision of $503,000 in 2006 and a provision of $313,000 in 2005. This is the result of a general improvement in credit quality and recoveries in 2007 of loans previously charged off.

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

- Total assets increased $310 million, or 30%, to $1.35 billion at the end of 2007 from $1.04 billion at the end of 2006. The increase in 2007 was primarily due to the acquisition of Diablo Valley Bank.

- Total loans increased $327 million, or 46%, to $1.04 billion at the end of 2007. Total loans were $709 million at the end of 2006. The increase in 2007 was primarily due to the acquisition of Diablo Valley Bank and the addition of several experienced loan producers hired in the fourth quarter.

- Nonperforming assets remained at nominal levels. Nonperforming assets were $4.5 million, or 0.34% of total assets, at December 31, 2007, compared to $4.3 million, or 0.42% of total assets, at December 31, 2006, and $3.7 million, or 0.32% of total assets, at December 31, 2005. Approximately $2.4 million of the nonperforming loans at year end of 2007 were acquired in the acquisition of Diablo Valley Bank.

- Total deposits increased $218 million, or 26%, to $1.06 billion at the end of 2007 from $847 million at the end of 2006. The increase in 2007 was primarily due to the acquisition of Diablo Valley Bank.

Deposits

Growth in deposits is an important metric management uses to measure market share. The Company's depositors are predominately located in its primary market area. Depending on loan demand and other funding requirements, the Company will occasionally obtain deposits from wholesale sources including deposit brokers. The Company had $40 million in brokered deposits at December 31, 2007. The Company also seeks deposits from title insurance companies and real estate exchange facilitators. 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. The Company's acquisition of Diablo Valley Bank during 2007 resulted a significant growth in deposits and expanded the Company's market area.

Lending

Our lending business originates primarily through our branch offices located in our primary market. The economy in our primary service area continued to stabilize in 2007. Commercial loans increased from December 31, 2006 due to increased marketing focus and the acquisition of Diablo Valley Bank. Commercial real estate mortgage loans slightly increased from December 31, 2006 primarily due to general improvements in commercial income property markets and the Diablo Valley Bank acquisition. We will continue to use and improve existing products to expand market share at current locations, including our new branch in Walnut Creek, California that opened in 2007.

Net Interest Income

The management of interest income and interest 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).

Because of its focus on commercial lending to closely held businesses, the Company will continue to have a high percentage of floating rate loans and other assets. Given the current volume, mix and repricing characteristics of our interest-bearing liabilities and interest-earning assets, we believe our interest rate spread is expected to increase in a rising rate environment, and decrease in a declining interest rate scenario.

During the fourth quarter of 2007, the Board of Governors of the Federal Reserve System reduced short-term interest rates by 50 basis points. This decrease in short-term rates immediately affected the rates applicable to the majority of the Company's loans. While the decrease in interest rates also lowered the cost of interest bearing deposits, which represent the Company's primary funding source, these deposits tend to reprice more slowly than floating rate loans. The Federal Reserve reduced short-term interest rates by another 125 points in January 2008. Reductions in short-term interest rates can be expected to negatively affect the Company's net interest margin and net interest income, at least in the near term.

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.

Management of Credit Risk

Because of its focus on business banking, loans to single borrowing entities are often larger than would be found in a more consumer oriented bank with many smaller, more homogenous loans. The average size of its relationships makes the Company more susceptible to larger losses. As a result of this concentration of larger risks, the Company has maintained an allowance for loan losses which is substantially higher than would be indicated by its actual historic loss experience. The Company had a reverse provision for loan losses each of the last two years because of a general improvement in credit quality and net recoveries in 2007 of loans previously charged off. A complete discussion of the management of credit risk appears under Provision for Loan Losses and Allowance for Loan Losses.

Noninterest Income

While net interest income remains the largest single component of total revenues, noninterest income is an important component. Prior to the third quarter of 2007, a significant percentage of the Company's noninterest income was associated with its SBA lending activity, as gains on the sale of loans sold in the secondary market and servicing income from loans sold in the secondary market with servicing rights retained. However, beginning in the third quarter of 2007, the Company started retaining new SBA loans in lieu of selling. As a result, the Company's noninterest income declined in 2007 compared to 2006. SBA loan activity includes the origination, sale, and servicing of loans guaranteed by the U.S. Department of Agriculture. Noninterest income associated with SBA activity increased each year from 2003 through 2006.

Noninterest Expense

Management considers the control of operating expenses to be a critical element of the Company's performance. Prior to 2007 the Company had undertaken several initiatives to reduce its noninterest expense and improve its efficiency, including a reduction in staff and the consolidation of operations under the common Heritage Bank brand and restructuring each department. In 2007, however, the Company's efficiency ratio was significantly impacted by the acquisition of Diablo Valley Bank, the hiring of additional experienced bankers and a new SBA team. Management monitors progress in reducing expense through the review of the Company's efficiency ratio. The Company's efficiency ratio was 62.81% in 2007 compared with 56.86% in 2006, and 61.52% in 2005.

In the fourth quarter of 2005, the Company recognized additional expenses of $1.05 million, representing the present value of term insurance for participants in the Company's Supplemental Executive Retirement Plan, substantially all of whom have split dollar life insurance agreements with the Company. Typically, under the split dollar life insurance agreements, the insureds' beneficiary receives 80% of the excess of the death benefit over the cash surrender value of the policy. This accounting adjustment was undertaken after the Company's review of split dollar life insurance agreements and recognition that the Company has contractually agreed with each participant to provide a benefit. This charge reflected the term insurance cost for all insureds.

Beginning in 2008, the Company will be impacted by the FASB Emerging Issues Task Force Issue No. 06-4, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements. This issue requires that a liability be recorded during the service period when a split-dollar life insurance agreement continues after participants' employment or retirement. With its existing split dollar life insurance agreements, the Company has contractually agreed with each participant to provide life insurance on an ongoing basis. Therefore, the Company would have to obtain term insurance for the remainder of the participant's life, or a comparable death benefit if the respective life insurance policy were ever terminated. The required accrued liability will be based on either the post-employment benefit cost for the continuing life insurance or on the future death benefit depending on the contractual terms of the underlying agreement.

In September 2006, FASB issued Statement 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans – an amendment of FASB Statements No. 87, 88, 106 and 132 (R). Adoption of Statement 158 did not affect the Company's financial statements since the Company's supplemental retirement plan has no assets and the liability for benefits is measured as of December 31 and recorded on the Company's balance sheet.

Capital Management and Share Repurchases

Heritage Commerce Corp and Heritage Bank of Commerce meet the regulatory definition of "well capitalized" at December 31, 2007. As part of its asset and liability process, the Company continually assesses its capital position to take into consideration growth, expected earnings, risk profile and potential corporate activities that it may choose to pursue. As a part of this process, the Company determined in the second quarter of 2004 that its capital levels were higher than necessary. To adjust capital to levels consistent with its view of current market conditions, the Company commenced a stock repurchase plan of $10 million in June 2004. This repurchase program was completed at the end of third quarter of 2005. On February 7, 2006, the Board of Directors authorized the repurchase of up to an additional $10 million of common stock through June 30, 2007. This repurchase program was completed at the end of second quarter of 2007. On July, 2007, the Board of Directors authorized to purchase up to $30 million of common stock through July, 2009.

In 2006, the Company initiated the payment of quarterly cash dividends. The Company paid cash dividends totaling $3.25 million, or $0.26 per share in 2007, representing 23% of 2007 earnings. The Company's general policy is to pay cash dividends within the range of typical peer payout ratios, provided that such payments do not adversely affect our financial condition and are not overly restrictive to our growth capacity. On January 30, 2008, the Company declared an $0.08 per share quarterly cash dividend. The dividend will be paid on March 19, 2008, to shareholders of record on February 27, 2008.

Results of Operations

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

Net Interest Income and Net Interest Margin

In 2007, net interest income was $51.7 million, an increase of 3% compared to $50.4 million in 2006. 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 which comprise the Company’s earning assets, deposits, and other interest-bearing liabilities. To maintain its net interest margin, the Company must manage the relationship between interest earned and paid.

The following Distribution, Rate and Yield table presents 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.

Distribution, Rate and Yield

	Year Ended December 31,								
	2007			2006			2005		
(Dollars in thousands)	Average Balance	Interest Income / Expense	Average Yield / Rate	Average Balance	Interest Income / Expense	Average Yield / Rate	Average Balance	Interest Income / Expense	Average Yield / Rate
Assets:									
Loans, gross (1)	$ 844,928	$ 68,405	8.10%	$ 738,297	$ 61,859	8.38%	$ 762,328	$ 54,643	7.17%
Securities	165,884	7,636	4.60%	191,220	7,796	4.08%	226,043	7,247	3.21%
Interest bearing deposits in other financial institutions	3,132	141	4.50%	2,826	132	4.67%	3,234	97	3.00%
Federal funds sold	49,118	2,530	5.15%	63,739	3,170	4.97%	52,438	1,769	3.37%
Total interest earning assets	1,063,062	78,712	7.40%	996,082	72,957	7.32%	1,044,043	63,756	6.11%
Cash and due from banks	37,435			34,810			38,670		
Premises and equipment, net	6,218			2,482			2,879		
Other assets	87,175			64,904			51,593		
Total assets	$ 1,193,890			$ 1,098,278			$ 1,137,185		
Liabilities and shareholders' equity:									
Deposits:									
Demand, interest bearing	$ 143,801	$ 3,154	2.19%	$ 145,471	$ 3,220	2.21%	$ 134,412	$ 1,749	1.30%
Savings and money market	393,750	12,368	3.14%	358,846	10,274	2.86%	363,570	6,058	1.67%
Time deposits, under $100	32,196	1,243	3.86%	31,967	1,037	3.24%	37,260	862	2.31%
Time deposits, $100 and over	119,812	5,151	4.30%	107,387	3,762	3.50%	115,104	2,867	2.49%
Brokered time deposits, $100 and over	49,846	2,295	4.60%	34,234	1,295	3.78%	35,764	1,313	3.67%
Notes payable to subsidiary grantor trusts	23,702	2,329	9.83%	23,702	2,310	9.75%	23,702	2,136	9.01%
Securities sold under agreement to repurchase	14,529	387	2.66%	25,429	627	2.47%	40,748	922	2.26%
Other short-term borrowings	1,726	85	4.92%	-	-	N/A	-	-	N/A
	779,362	27,012	3.47%	727,036	22,525	3.10%	750,560	15,907	2.12%

Total interest bearing liabilities									
Demand, noninterest bearing	242,308			229,190			259,881		
Other liabilities	23,385			23,957			21,536		
Total liabilities	1,045,055			980,183			1,031,977		
Shareholders' equity	148,835			118,095			105,208		
Total liabilities and shareholders' equity	$ 1,193,890			$ 1,098,278			$ 1,137,185		
Net interest income / margin		$ 51,700	4.86%		$ 50,432	5.06%		$ 47,849	4.58%

(1) Yields and amounts earned on loans include loan fees and costs. Nonaccrual loans are included in the average balance calculations above.

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

Volume and Rate Variances

	2007 vs. 2006			2006 vs. 2005		
	Increase (Decrease) Due to Change in:			Increase (Decrease) Due to Change in:		
(Dollars in thousands)	Average Volume	Average Rate	Net Change	Average Volume	Average Rate	Net Change
Income from the interest earning assets:						
Loans, gross	$ 8,633	$ (2,087)	$ 6,546	$ (2,024)	$ 9,240	$ 7,216
Securities	(1,160)	1,000	(160)	(1,427)	1,976	549
Interest bearing deposits in other financial institutions	14	(5)	9	(19)	54	35
Federal funds sold	(753)	113	(640)	564	837	1,401
Total interest income on interest earning assets	$ 6,734	$ (979)	$ 5,755	$ (2,906)	$ 12,107	$ 9,201
Expense from the interest bearing liabilities:						
Demand, interest bearing	$ (38)	$ (28)	$ (66)	$ 249	$ 1,222	$ 1,471
Savings and money market	1,100	994	2,094	(124)	4,340	4,216
Time deposits, under $100	9	197	206	(170)	345	175
Time deposits, $100 and over	533	856	1,389	(267)	1,162	895
Brokered time deposits, $100 and over	720	280	1,000	(57)	39	(18)
Notes payable to subsidiary grantor trusts	(1)	20	19	-	174	174
Securities sold under agreement to repurchase	(350)	110	(240)	(379)	84	(295)
Other short-term borrowings	85	-	85	-	-	-
Total interest expense on interest bearing liabilities	$ 2,059	$ 2,428	$ 4,487	$ (748)	$ 7,366	$ 6,618
Net interest income	$ 4,675	$ (3,407)	$ 1,268	$ (2,158)	$ 4,741	$ 2,583

Net interest income for 2007 increased $1.3 million or 3% from 2006. The increase in 2007 was primarily due to growth in the loan portfolio. Average earning assets increased 7% in 2007 from 2006. This increase was primarily attributable to the acquisition of Diablo Valley Bank. The Company's net interest margin, expressed as a percentage of average earning assets, was 4.86% in 2007 compared to 5.06% in 2006, a decrease of 20 basis points. A substantial portion of the Company's earning assets are variable-rate loans that re-price when the Company's prime lending rate is changed, in contrast to a large base of core deposits that are generally slower to re-price. This causes the Company's balance sheet to be asset-sensitive which means that, all else being equal, the Company's net interest margin will be lower during periods when short-term interest rates are falling and higher when rates are rising. Management anticipates that the Company's net interest margin could experience some compression if short-term interest rates continue to fall in 2008.

The net interest margin increased 48 basis points to 5.06% in 2006 from 4.58% in 2005. Net interest income increased $2.6 million, or 5%, for 2006 to $50.4 million from $47.8 million for 2005, primarily due to higher in interest rate levels in 2006.

Provision for Loan Losses

Credit risk is inherent in the business of making loans. The Company sets aside an allowance or reserve for loan losses through charges to earnings, which are shown in the income statement as the provision for loan losses. Specifically identifiable and quantifiable losses are immediately charged off against the allowance. The loan loss provision is determined by conducting a monthly evaluation of the adequacy of the Company's allowance for loan losses and charging the shortfall, if any, to the current month's expense. This has the effect of creating variability in the amount and frequency of charges to the Company's earnings. The loan loss provision 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.

For 2007, the Company had a credit provision for loan losses of $11,000, compared to a credit provision for loan losses of $0.5 million for 2006 and provision for loan losses of $0.3 million for 2005. The allowance for loan losses represented 1.18%, 1.31% and 1.51% of total loans at December 31, 2007, 2006 and 2005, respectively. See "Allowance for Loan Losses" on page 34 for additional information.

Noninterest Income

Beginning in the third quarter of 2007, the Company decided to change its strategy regarding its SBA loan business. The Company is now retaining most new SBA production in lieu of selling the loans. Reflecting the strategic shift to retain SBA loan production, gains from sale of loans dropped substantially in 2007.

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

Noninterest Income

	Year Ended December 31,			Increase (decrease) 2007 versus 2006		Increase (decrease) 2006 versus 2005	
(Dollars in thousands)	2007	2006	2005	Amount	Percent	Amount	Percent
Gain on sale of SBA loans	$ 1,766	$ 3,337	$ 2,871	$ (1,571)	-47%	$ 466	16%
Gain on sale Capital Group loan portfolio	-	671	-	(671)	-100%	671	N/A
Servicing income	2,181	1,860	1,838	321	17%	22	1%
Increase in cash surrender value of life insurance	1,443	1,439	1,236	4	-%	203	16%
Service charges and fees on deposit accounts	1,284	1,335	1,468	(51)	-4%	(133)	-9%
Gain on sale of leased equipment	-	-	299	-	N/A	(299)	-100%
Equipment leasing	-	-	131	-	N/A	(131)	-100%
Other	1,378	1,198	1,580	180	15%	(382)	-24%
Total	$ 8,052	$ 9,840	$ 9,423	$ (1,788)	-18%	$ 417	4%

The decrease in noninterest income in 2007 compared to 2006 was primarily attributable to a $2.2 million decrease in gain on sale of loans. The net gain on sale of SBA loans was $1.8 million for 2007, compared to $3.3 million for 2006. The reduction in noninterest income should be offset in future years with higher interest income, as a result of retaining SBA loan production..

For periods the Company sold its SBA loan production, including the first nine months of 2007, gains or losses on SBA loans held for sale were recognized upon completion of the sale, and are based on the difference between the net sales proceeds and the relative fair value of the guaranteed portion of the loan sold compared to the relative fair value of the unguaranteed portion. The servicing assets that resulted from the sale of SBA loans, with servicing rights retained, are amortized over the term of the loans using a method approximating the interest method.

Noninterest Expense

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

Noninterest Expense

	Year Ended December 31,			Increase (decrease) 2007 versus 2006		Increase (decrease) 2006 versus 2005	
(Dollars in thousands)	2007	2006	2005	Amount	Percent	Amount	Percent
Salaries and employee benefits	$ 21,160	$ 19,414	$ 19,845	$ 1,746	9%	$ (431)	-2%
Occupancy	3,557	3,110	3,254	447	14%	(144)	-4%
Professional fees	2,342	1,688	1,617	654	39%	71	4%
Advertising and promotion	1,092	1,064	985	28	3%	79	8%
Data processing expense	867	806	661	61	8%	145	22%
Low income housing investment losses and writedowns	828	995	957	(167)	-17%	38	4%
Client services	820	1,000	1,404	(180)	-18%	(404)	-29%
Furniture and equipment	638	517	734	121	23%	(217)	-30%
Intangible asset amortization	352	-	-	352	N/A	-	N/A
Retirement plan expense	274	352	619	(78)	-22%	(267)	-43%
Amortization of leased equipment	-	-	334	-	N/A	(334)	-100%
Other	5,600	5,322	4,823	278	5%	499	10%
Total	$ 37,530	$ 34,268	$ 35,233	$ 3,262	10%	(965)	-3%

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

Noninterest Expense by Category

	2007		2006		2005	
(Dollars in thousands)	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
Salaries and employee benefits	$ 21,160	56%	$ 19,414	57%	$ 19,845	56%
Occupancy	3,557	10%	3,110	9%	3,254	9%
Professional fees	2,342	6%	1,688	5%	1,617	5%
Advertising and promotion	1,092	3%	1,064	3%	985	3%
Data processing expense	867	2%	806	2%	661	2%
Low income housing investment losses and writedowns	828	2%	995	3%	957	3%
Client services	820	2%	1,000	3%	1,404	4%
Furniture and equipment	638	2%	517	1%	734	2%
Intangible asset amortization	352	1%	-	-%	-	-%
Retirement plan expense	274	1%	352	1%	619	2%
Amortization of leased equipment	-	-%	-	-%	334	1%
Other	5,600	15%	5,322	16%	4,823	13%
Total	$ 37,530	100%	$ 34,268	100%	$ 35,233	100%

Noninterest expense increased $3.3 million, or 10%, in 2007 compared to 2006. Noninterest expense for 2006 decreased $1.0 million, or 3%, from 2005. The efficiency ratio represents noninterest expense divided by the sum of net interest and noninterest income. The Company's efficiency ratio was 62.81% in 2007, as compared to 56.86% in 2006 and 61.52% in 2005.

The increase in compensation expense was primarily due to the acquisition of Diablo Valley Bank and the Company hiring a number of experienced bankers during 2007. Salary and severance benefits for former Diablo Valley Bank employees totaled $461,000. Up-front costs associated with the hiring of new bankers for the East Bay expansion and SBA teams totaled $970,000 in 2007. The increase in occupancy, furniture and equipment was due to opening a new branch office in Walnut Creek during 2007, as well as the addition of the Diablo Valley Bank offices. The increase in professional fees and data processing fees in 2007 were due to the acquisition of Diablo Valley Bank and additional branches and customer accounts after the merger with Diablo Valley Bank. The Company also incurred amortization expense of $352,000 related to intangible assets from the Diablo Valley Bank acquisition.

Income Tax Expense

The Company computes its provision for income taxes on a monthly basis. As indicated in Note 9 to the Consolidated Financial Statements, the amount of such provision 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, tax-exempt interest income, increases in the cash surrender value of life insurance policies, California Enterprise Zone deductions, certain expenses that are not allowed as tax deductions, and tax credits.

The Company's federal and state income tax expense was $8.1 million in 2007, compared to $9.2 million and $7.3 million for 2006 and 2005, respectively. This represents 36.6% of income before taxes in 2007, 34.8% in 2006, and 33.5% in 2005. The effective tax rate is higher in 2007, than in 2006 and 2005, because of adjustments in 2007 resulting from the audit of the Company's California state tax returns by the State of California Franchise Tax Board.

Tax-exempt interest income is generated primarily by the Company's investments in state, county and municipal securities, which provided $0.2 million in federal tax-exempt income in 2007, 2006 and 2005. Although not reflected in the investment portfolio, the Company also has total investments of $7.3 million in low-income housing limited partnerships as of December 31, 2007. These investments have generated tax credits for the past few years, with about $1.1 million in credits available for the 2007 tax year and $1.0 million in tax credits realized in 2006. The investments are expected to generate an additional $6.2 million in aggregate tax credits from 2008 through 2016; however, the credits are dependent upon the occupancy level of the housing projects and income of the tenants and cannot be projected with certainty.

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, which is accumulated on the Company's books as a deferred tax asset or deferred tax liability until such time as it reverses. At the end of 2007, the Company had a net deferred tax asset of $10.1 million.

Financial Condition

As of December 31, 2007, total assets were $1.35 billion, an increase of 30% from $1.04 billion at year-end 2006.   Total securities available-for-sale (at fair value) were $135 million, a decrease of 22% from $172 million at year-end 2006. The total loan portfolio (excluding loans held for sale) was $1.04 billion, an increase of 46% from $709 million at year-end 2006. Total deposits were $1.064 billion, an increase of 26% from $846 million at year-end 2006. Securities sold under agreement to repurchase decreased $10.9 million, or 50%, to $10.9 million at December 31, 2007, from $21.8 million at year-end 2006.

Securities Portfolio

The following table reflects the estimated fair value for each category of securities for the past three years.

Investment Portfolio

	December 31,		
(Dollars in thousands)	2007	2006	2005
Securities available-for-sale (at fair value)			
U.S. Treasury	$ 4,991	$ 5,963	$ 6,920
U.S. Government Agencies	35,803	59,396	82,041
Municipals - Tax Exempt	4,114	8,142	8,268
Mortgage-Backed Securities	83,046	90,186	91,868

Collateralized Mortgage Obligations	7,448	8,611	9,398
Total	$ 135,402	$ 172,298	$ 198,495

Securities classified as U.S. Government Agencies as of December 31, 2007 were issued by the Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, and the Federal Home Loan Bank.

The following table summarizes the maturities and weighted average yields of securities as of December 31, 2007:

	December 31, 2007 Maturity									
	Within One Year		After One and Within Five Years		After Five and Within Ten Years		After Ten Years		Total	
(Dollars in thousands)	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
Securities available-for-sale (at fair value):										
U.S. Treasury	$ 4,991	4.77%	$ -	-	$ -	-	$ -	-	$ 4,991	4.77%
U.S. Government Agencies	24,260	4.92%	11,543	4.51%	-	-	-	-	35,803	4.79%
Municipals - non-taxable	3,421	3.04%	693	3.88%	-	-	-	-	4,114	3.18%
Mortgage Backed Securities	-	-	1,743	3.00%	12,497	4.64%	68,806	4.53%	83,046	4.51%
Collateralized Mortgage Obligations	-	-	-	-	5,001	5.50%	2,447	3.16%	7,448	4.73%
Total	$ 32,672	4.70%	$ 13,979	4.29%	$ 17,498	4.89%	$ 71,253	4.48%	$ 135,402	4.57%

The investment 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 any analysis of the financial condition of the Company. The investment portfolio serves the following purposes: (i) it can be readily reduced in size to provide liquidity for loan balance increases or deposit balance decreases; (ii) 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; (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; (iv) it is an alternative interest-earning use of funds when loan demand is weak or when deposits grow more rapidly than loans; and (v) it can enhance the Company's tax position by providing partially tax exempt income.

The Company uses two portfolio classifications for its securities: "Held-to-maturity", and "Available-for-sale". Accounting rules also allow for a trading portfolio classification, but the Company has no securities that would be classified as such. The held-to-maturity portfolio can consist only of securities that the Company has both the intent and ability to hold until maturity, to be sold only in the event of concerns with an issuer's credit worthiness, a change in tax law that eliminates their tax exempt status, or other infrequent situations as permitted by generally accepted accounting principles. Since the Company does not have a trading portfolio, the available-for-sale portfolio is comprised of all securities not included as "held-to-maturity". Even though management currently has the intent and the ability to hold the Company's securities for the foreseeable future, they are all currently classified as available-for-sale to allow flexibility with regard to the active management of the Company's investment portfolio. FASB Statement 115 requires available-for-sale securities to be marked to market with an offset to accumulated other comprehensive income, a component of shareholders' equity. Monthly adjustments are made to reflect changes in the market value of the Company's available-for-sale securities.

The Company's investment portfolio is currently composed primarily of: (i) U.S. Treasury and Agency issues 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) state, county and municipal obligations, which provide tax free income and limited pledging potential; and (iv) collateralized mortgage obligations, which generally enhance the yield of the portfolio. The amortized cost of securities pledged as collateral for repurchase agreements, public deposits and for other purposes as required or permitted by law was $42.2 million and $53.7 million at December 31, 2007 and 2006, respectively.

Except for obligations of the U.S. government or U.S. government agencies, no securities of a single issuer exceeded 10% of shareholders' equity at December 31, 2007. The Company has not used interest rate swaps or other derivative instruments to hedge fixed rate loans or to otherwise mitigate interest rate risk.

In 2007, the investment portfolio declined by $37 million, or 21%, and decreased to 10% of total assets at the end of 2007 from 16.6% at the end of 2006. U.S. Treasury and U.S. Government Agency securities decreased to 30% of the portfolio at the end of 2007 from 38% at the end of 2006. The decrease was primarily due to maturities of U.S. Government Agency securities during 2007. Municipal securities also decreased by 49% in 2007, due to maturities. Mortgage-backed securities and collateralized mortgage obligations remained fairly constant in the portfolio in 2007 compared to 2006.

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 represented 77% of total assets at December 31, 2007, as compared to 68% of at December 31, 2006. The ratio of loans to deposits increased to 97% at the end of 2007 from 84% at the end of 2006. Demand for loans remains relatively strong in many areas within the Company's markets and competition continues to intensify. To help ensure that we remain competitive, we make every effort to be flexible and creative in our approach to structuring loans.

The Selected Financial Data table in Item 6 reflects the amount of loans outstanding at December 31st for each year from 2003 through 2007, net of deferred fees and origination costs and the allowance for loan losses. The Loan Distribution table that follows sets forth the Company's gross loans outstanding and the percentage distribution in each category at the dates indicated. The amounts shown in the table do not reflect any deferred loan fees or deferred origination costs, nor is the allowance for loan loss deducted.

Loan Distribution

	December 31,									
(Dollars in thousands)	2007	% to Total	2006	% to Total	2005	% to Total	2004	% to Total	2003	% to Total
Commercial	$ 411,251	40%	$ 284,093	40%	$ 248,060	37%	$ 296,030	41%	$ 269,076	41%
Real estate - mortgage	361,211	35%	239,041	34%	237,566	35%	250,984	35%	227,474	35%
Real estate - land and construction	215,597	21%	143,834	20%	149,851	22%	118,290	17%	101,082	16%
Home equity	44,187	4%	38,976	6%	41,772	6%	52,170	7%	49,434	8%
Consumer	3,044	0%	2,422	0%	1,721	0%	2,908	0%	1,743	0%
Total loans	1,035,290	100%	708,366	100%	678,970	100%	720,382	100%	648,809	100%
Deferred loan costs, net	1,175		870		1,155		726		863	
Allowance for loan losses	(12,218)		(9,279)		(10,224)		(12,497)		(13,451)	
Loans, net	$ 1,024,247		$ 699,957		$ 669,901		$ 708,611		$ 636,221	

Total loans (excluding loans held for sale) were $1.035 billion at December 31, 2007, an increase of 46% from $708 million at December 31, 2006. Total loans increased by $386 million, or 60%, from the end of 2003 to the end of 2007.

The Company's loan portfolio is concentrated in commercial, primarily manufacturing, wholesale, and services and real estate, with the balance in land development and construction and home equity and consumer loans. The loan portfolio mix over the past five years has remained relatively the same.

The change in the Company's loan portfolio in 2007 from 2006 is primarily due to the acquisition of DVB. The Company does not have any concentrations by industry or group of industries in its loan portfolio; however, 60% of its net loans were secured by real property as of December 31, 2007 and 2006. 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. In the fourth quarter of 2005, the Company entered into negotiations for the sale of its Capital Group loan portfolio consisting primarily of "factoring" type loans. In contemplation of the sale, $32 million, net of the respective allowance loan loss, was moved from commercial loans into loans held-for-sale. The sale of the Capital Group loan portfolio was completed in 2006, resulting in a gain of $0.7 million.

The Company's commercial loans are made for working capital, financing the purchase of equipment or for other business purposes. Such loans include loans with maturities ranging from thirty days to one year and "term loans," with maturities normally ranging from one to five years. Short-term business loans are generally intended to finance current transactions and typically provide for periodic principal payments, with interest payable monthly. Term loans normally provide for floating interest rates, with monthly payments of both principal and interest. The Company's commercial loans are centered in locally-oriented commercial activities in markets where the Company has a physical presence, and these markets have become more competitive as business activity has moderated.

The Company is an active participant in the Small Business Administration ("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 SBA-guaranteed loans. Prior to third quarter of 2007, the guaranteed portion of these loans were sold in the secondary market depending on market conditions. Once it was determined that these loans would be sold, these loans were classified as held for sale and carried at the lower of cost or market. When the guaranteed portion of an SBA loan, was sold, the Company retained the servicing rights for the sold portion. As of December 31, 2007, 2006, and 2005, $177 million, $189 million and $180 million, respectively, in SBA and U.S. Department of Agriculture loans were serviced by the Company for others. As discussed on page 28, beginning in the third quarter of 2007, the Company changed its strategy regarding its SBA loan business by retaining new SBA production in lieu of selling the loans.

As of December 31, 2007, real estate mortgage loans of $360 million consist of adjustable and fixed rate loans secured by commercial property, and loans secured by first mortgages on 1-4 family residential properties of $1 million. Of the $216 million in land and construction loans at Decemeber 31, 2007, $157 million was construction loans comprised of $92 million residential and $65 million commercial. The other $59 million of land and construction loans represent residential land loans of $46 million residential and $13 million of commercial land loans. Properties securing the real estate mortgage loans are primarily located in the Company's market area. While no specific industry concentration is considered significant, the Company's lending operations are located in market areas that are dependent on the technology and real estate industries and their supporting companies. Real estate values in portions of Santa Clara County and neighboring San Mateo County are among the highest in the country at present but have recently been experiencing a decrease in value from the levels experienced at the beginning of 2007. The Company's borrowers could be adversely impacted by a downturn in these sectors of the economy, which could reduce the demand for loans and adversely impact the borrowers' ability to repay their loans.

The Company's real estate term loans consist primarily of loans made based on the borrower's cash flow and are secured by deeds of trust on commercial and residential property to provide a secondary source of repayment. The Company generally restricts real estate term loans to no more than 80% of the property's appraised value or the purchase price of the property, depending on the type of property and its utilization. The Company offers both fixed and floating rate loans. Maturities on such loans are generally 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 are easily sold in the secondary market may be granted for longer maturities.

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

The Company makes consumer loans for the purpose of financing automobiles, various types of consumer goods, and other personal purposes. Additionally, the Company makes home equity lines of credit available to its clientele. Consumer loans generally provide for the monthly payment of principal and interest. Most of the Company's consumer loans are secured by the personal property being purchased or, in the instances of home equity loans or lines, real property.

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 $29 million and $48 million at December 31, 2007, respectively.

Loan Maturities

The following table presents the maturity distribution of the Company's loans as of December 31, 2007. 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, 2007, approximately 71% of the Company's loan portfolio consisted of floating interest rate loans.

Loan Maturities

(Dollars in thousands)	Due in One Year or Less	Over One Year But Less than Five Years	Over Five Years	Total
Commercial	$ 369,575	$ 30,378	$ 11,298	$ 411,251

Real estate - mortgage	112,553	154,145	94,513	361,211
Real estate - land and construction	213,565	2,032	-	215,597
Home equity	38,097	-	6,090	44,187
Consumer	1,723	1,321	-	3,044
Total loans	$ 735,513	$ 187,876	$ 111,901	$ 1,035,290
Loans with variable interest rates	$ 668,970	$ 52,081	$ 9,333	$ 730,384
Loans with fixed interest rates	66,543	135,795	102,568	304,906
Total loans	$ 735,513	$ 187,876	$ 111,901	$ 1,035,290

Nonperforming Assets

Financial institutions generally have a certain level of exposure to asset 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 asset 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, or as a result of the downturns in national and regional economies which have brought about declines in overall property values. 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.

To help minimize credit quality concerns, we have established a sound approach to credit that includes well-defined goals and objectives and well-documented credit policies and procedures. The 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 and lease 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 a multi-community independent bank serving a specific geographic area, the Company must contend with the unpredictable changes of both the general California 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; loans 90 days or more past due and still accruing interest (although they are generally placed on non-accrual when they become 90 days past due unless they are both well secured and in the process of collection); loans restructured where the terms of repayment have been renegotiated, resulting in a deferral of interest or principal; and other real estate owned ("OREO"). Management's classification of a loan as "non-accrual" 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, reverses any uncollected interest that had been accrued as income, and begins recognizing interest income only as cash interest payments are received as long as the collection of all outstanding principal is not in doubt. The loans may or may not be collateralized, and collection efforts are continuously 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. OREO consists of properties acquired by foreclosure or similar means that management is offering or will offer for sale.

The following table provides information with respect to components of the Company's non-performing assets at the dates indicated.

Nonperforming Assets

	December 31,				
(Dollars in thousands)	2007	2006	2005	2004	2003
Nonaccrual loans	$ 3,363	$ 3,866	$ 3,672	$ 1,028	$ 3,972
Loans 90 days past due and still accruing	101	451	-	302	608
Total nonperforming loans	3,464	4,317	3,672	1,330	4,580

Other real estate owned		1,062		-		-		-		-
Total nonperforming assets	$	4,526	$	4,317	$	3,672	$	1,330	$	4,580
Nonperforming assets as a percentage of loans plus other real estate owned		0.44%		0.61%		0.54%		0.18%		0.70%

The balance of nonperforming assets at the end of 2007 represents an increase of $0.2 million, or 5%, from year-end 2006 levels. Nonperforming assets increased by $0.6 million, or 18%, in 2006 as compared to 2005.

While the current level of nonperforming assets is relatively low, we recognize that an increase in the dollar amount of nonaccrual loans is possible in the normal course of business as we expand our lending activities.

Allowance for Loan Losses

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

Management conducts a critical evaluation of the loan portfolio monthly. This evaluation includes periodic loan by loan review for certain loans to evaluate the level of impairment, as well as detailed reviews of other loans (either individually or in pools) based on an assessment of the following factors: past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, collateral values, loan volumes and concentrations, size and complexity of the loans, recent loss experience in particular segments of the portfolio, bank regulatory examination and independent loan review results, and current economic conditions in the Company's marketplace, in particular the state of the technology industry and the real estate market. This process attempts to assess the risk of loss inherent in the portfolio by segregating loans into two categories for purposes of determining an appropriate level of the allowance: Loans graded "Pass through Special Mention" and "Substandard."

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

Specific allowances are established for impaired loans. Management considers a loan to be impaired when it is probable that the Company will be unable to collect all amounts due according to the original contractual terms of the note agreement. When a loan is considered to be impaired, the amount of impairment is measured based on the fair value of the collateral if the loan is collateral dependent or on the present value of expected future cash flow.

The formula portion of the allowance is calculated by applying loss factors to pools of outstanding loans. Loss factors are based on the Company's historical loss experience, adjusted for significant factors that, in management's judgment, affect the collectibility of the portfolio as of the evaluation date. The adjustment factors for the formula allowance may include existing general economic and business conditions affecting the key lending areas of the Company, in particular the real estate market, credit quality trends, collateral values, loan volumes and concentrations, the technology industry and specific industry conditions within portfolio segments, recent loss experience in particular segments of the portfolio, duration of the current business cycle, and bank regulatory examination results. The evaluation of the inherent loss with respect to these conditions is subject to a higher degree of uncertainty.

Loans that demonstrate a weakness, for which there is a possibility of loss if the weakness is not corrected, are categorized as "classified." Classified loans include all loans considered as substandard, doubtful, and loss and may result from problems specific to a borrower's business or from economic downturns that affect the borrower's ability to repay or that cause a decline in the value of the underlying collateral (particularly real estate). The principal balance of classified loans, which include all loans internally graded as substandard, doubtful, and loss, was $25.2 million, $24.5 million, and $16.3 million, respectively, at December 31, 2007, 2006, and 2005. At December 31, 2007 and 2006, all of the Company's classified loans were graded as substandard.

In adjusting the historical loss factors applied to the respective segments of the loan portfolio, management considered the following factors:

- Levels and trends in delinquencies, non-accruals, charge offs and recoveries
- Trends in volume and loan terms
- Lending policy or procedural changes
- Experience, ability, and depth of lending management and staff
- National and local economic trends and conditions
- Concentrations of Credit

There can be no assurance that the adverse impact of any of these conditions on HBC will not be in excess of the current level of estimated losses.

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

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

Allowance for Loan Losses

(Dollars in thousands)	2007	2006	2005	2004	2003
Balance, beginning of year	$ 9,279	$ 10,224	$ 12,497	$ 13,451	$ 13,227
Charge-offs:					
Commercial	(84)	(291)	(3,273)	(2,901)	(2,906)
Real estate - mortgage	-	-	-	-	-
Real estate - land and construction	-	-	-	-	-
Home equity	(20)	(540)	-	-	-
Consumer	-	-	-	-	-
Total charge-offs	(104)	(831)	(3,273)	(2,901)	(2,906)
Recoveries:					
Commercial	929	389	1,358	1,562	230
Real estate - mortgage	-	-	-	-	-
Real estate - land and construction	-	-	-	-	-
Home equity	-	-	-	-	-
Consumer	-	-	-	-	-
Total recoveries	929	389	1,358	1,562	230
Net recoveries (charge-offs)	825	(442)	(1,915)	(1,339)	(2,676)
Provision for loan losses	(11)	(503)	313	666	2,900
Reclassification of allowance for loan losses	-	-	(671)(1)	-	-
Reclassification to other liabilities	-	-	-	(281)(2)	-
Allowance acquired in bank acquisition	2,125	-	-	-	-
Balance, end of year	$ 12,218	$ 9,279	$ 10,224	$ 12,497	$ 13,451
RATIOS:					
Net charge-offs to average loans *	(0.10)%	0.06%	0.28%	0.19%	0.41%
Allowance for loan losses to total loans *	1.18%	1.31%	1.51%	1.73%	2.03%
Allowance for loan losses to nonperforming loans	353%	215%	278%	940%	294%

* Average loans and total loans exclude loans held for sale

(1) The Company reclassified $0.7 million of the allowance allocated to $32 million of commercial asset based loans that were reclassified to loans held-for-sale as of December 31, 2005. Thus, the carrying value of these loans held-for-sale includes an allowance for loan losses of $0.7 million.

(2) The Company reclassified estimated losses on unused commitments of $0.3 million to other liabilities as of December 31, 2004.

The Company's allowance for loan losses increased $2.9 million in 2007 as compared to 2006. The allowance for loan losses increased primarily as a result of the Diablo Valley Bank acquistion. The Company had $929,000 in recoveries in 2007, which were partially offset by loan charge-offs of $104,000. The Company had a credit provision of $11,000 in 2007, compared to a credit provision of $503,000 in 2006. Previously, the Company's allowance for loan losses had steadily decreased from 2003 through 2006.

Net loans charged-off reflect the realization of losses in the portfolio that were recognized previously though provisions for loan losses. Net recoveries were $0.8 million in 2007, compared to net charged-offs of $0.4 million, and $1.9 million in 2006 and 2005, respectively. The decrease in net loan charge-offs in 2007 was primarily due to continued improvement in credit quality and a $700,000 recovery on a loan charged off in 2005. Historical net loan charge-offs are not necessarily indicative of the amount of net charge-offs that the Company will realize in the future.

The Company's unallocated allowance was $1.4 million as of December 31, 2007 and 2006. The unallocated component of the allowance is maintained to cover uncertainties that could affect management's estimate of probable losses.

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

Allocation of Loan Loss Allowance

	December 31,									
	2007		2006		2005		2004		2003	
(Dollars in thousands)	Allowance	Percent of Loans in each category to total loans	Allowance	Percent of Loans in each category to total loans	Allowance	Percent of Loans in each category to total loans	Allowance	Percent of Loans in each category to total loans	Allowance	Percent of Loans in each category to total loans
Commercial	$ 6,067	40%	$ 4,872	40%	$ 4,199	37%	$ 8,691	41%	$ 9,667	41%
Real estate - mortgage	2,416	35%	1,507	34%	2,631	35%	1,498	35%	1,846	35%
Real estate - land and construction	1,923	21%	1,243	20%	1,914	22%	1,711	17%	1,714	16%
Home equity	335	4%	244	6%	300	6%	173	7%	157	8%
Consumer	88	0%	24	0%	33	0%	38	0%	37	0%
Unallocated	1,389	0%	1,389	0%	1,147	0%	386	0%	30	0%
%Total	$ 12,218	100%	$ 9,279	100%	$ 10,224	100%	$ 12,497	100%	$ 13,451	100

Deposits

The composition and cost of the Company's deposit base are important components in analyzing the Company's net interest margin and balance sheet liquidity characteristics, both of which are discussed in greater detail in other sections herein. Our net interest margin is improved to the extent that growth in deposits can be concentrated in historically lower-cost deposits such as non-interest-bearing demand, NOW accounts, savings accounts and money market deposit accounts. The Company's liquidity is impacted by the volatility of deposits or other funding instruments, or in other words, by the propensity of that money to leave the institution for rate-related or other reasons. Potentially, the most volatile deposits in a financial institution are jumbo certificates of deposit, meaning time deposits with balances that equal or exceed $100,000, as customers with balances of that magnitude are typically more rate-sensitive than customers with smaller balances.

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

Deposits

	Years Ended December 31,					
	2007		2006		2005	
(Dollars in thousands)	Balance	% to Total	Balance	% to Total	Balance	% to Total
Demand, noninterest bearing	$ 268,005	25%	$ 231,841	27%	$ 248,009	26%
Demand, interest bearing	150,527	14%	133,413	16%	157,330	17%
Savings and money market	432,293	41%	307,266	36%	353,798	38%

Time deposits, under $100		34,092	3%		31,097	4%		35,209	4%
Time deposits, $100 and over		139,562	13%		111,017	13%		109,373	12%
Brokered deposits, $100 and over		39,747	4%		31,959	4%		36,040	4%
Total deposits	$	1,064,226	100%	$	846,593	100%	$	939,759	100%

Total deposits were $1.06 billion at December 31, 2007, an increase of $218 million, or 26%, compared to $846.6 million at December 31, 2006. The increases primarily reflect the acquisition of Diablo Valley Bank. At December 31, 2007, compared to December 31, 2006, noninterest bearing demand deposits increased $36 million, or 16%; interest bearing demand deposits increased $17 million, or 13%; savings and money market deposits increased $125 million, or 41%; time deposits increased $32 million, or 22%; and brokered deposits increased $8 million, or 24%.

As of December 31, 2007, approximately $7.7 million, or less than 1%, of deposits were from public sources, and approximately $117.1 million, or 11%, of deposits were from real estate exchange company and title company accounts. As of December 31, 2006, approximately $2.4 million, or less than 1%, of deposits were from public sources, and approximately $108.2 million, or 13%, of deposits were from real estate exchange company and title company accounts.

Among core deposits categories, noninterest demand deposits increased by $36 million or 16% in 2007. Furthermore, relatively low-cost NOW accounts increased by $17 million or 13%. Savings and money market accounts increased by $125 million, or 41%, and time deposits increased in absolute dollars but remained flat as a percentage of total deposits. Our increase in savings and money market accounts was primarily the result of the acquisition of Diablo Valley Bank. While our core deposit accounts increased in number to 15,400 at the end of 2007 from 13,200 at the end of 2006, the average balance per core deposit increased to about $57,000 at the end of 2007 from $53,000 at the end of 2006.

Without the acquisition of Diablo Valley Bank, total deposits would have been relatively flat. The Company faces intensified competition for deposits as core deposits migrate into higher-yielding alternatives, including equity markets.

The Company obtains deposits from a cross-section of the communities it serves. The Company's business is not seasonal in nature. The Company had brokered deposits totaling approximately $39.7 million, and $32.0 million at December 31, 2007 and 2006, respectively. These brokered deposits generally mature within one to three years. The Company is not dependent upon funds from sources outside the United States.

The following table indicates the maturity schedule of the Company's time deposits of $100,000 or more as of December 31, 2007:

Deposit Maturity Distribution

(Dollars in thousands)		Balance	% of Total
Three months or less	$	70,180	39%
Over three months through six months		52,505	30%
Over six months through twelve months		39,976	22%
Over twelve months		16,	