

HERITAGE
BANK OF COMMERCE

March 9, 2009

VIA EMAIL AND REGULAR MAIL

Mr. Neil M. Barofsky
Special Inspector General
Troubled Asset Relief Program
UNITED STATES DEPARTMENT OF THE TREASURY
1500 Pennsylvania Avenue, N.W., Suite 1064
Washington, D.C. 20220
Email: SIGTARP.response@do.treas.gov

Re: Heritage Commerce Corp – UST Sequence Number 0055-
Report on TARP funds

Dear Mr. Barofsky:

This letter is in response to your request dated February 6, 2009, for a report on our use and plans for funds from the Troubled Asset Recovery Program (“TARP”) in the amount of \$40 million received by Heritage Commerce Corp on November 21, 2008. We welcome this opportunity to provide you with this information and recognize the importance of the information for monitoring the success of the TARP program.

Heritage Commerce Corp (“HCC”) is registered with the Board of Governor of the Federal Reserve System. It is also a registered public company pursuant to the Securities Exchange Act of 1934 and files periodic reports with the Securities and Exchange Commission (“SEC”). The common stock of HCC is listed on the NASDAQ Global Select Stock Market. HCC is the parent company of Heritage Bank of Commerce, a California state chartered bank (the “Bank”) (HCC and the Bank are sometimes, collectively referred to as the “Company”). HCC has no other operating subsidiaries. HCC’s principal source of income is dividends from the Bank. The expenditures of HCC, including the payment of dividends to shareholders, if and when declared by the board of directors, cost of servicing debt, legal fees, audit fees, and shareholder costs are generally paid from dividends paid to the HCC by the Bank and a line of credit advanced to HCC by a correspondent bank. The only other direct subsidiaries of HCC are various trusts which were formed solely to facilitate the issuance of trust preferred securities, the proceeds of which were downstreamed to the Bank to enhance regulatory capital and liquidity and otherwise support the business of the Bank.

We invite you to review our SEC filings for more information about HCC and the Bank, including the matters discussed below. We also note that some of the information provided to you in this letter may constitute non public information. We have assumed that the contents of this letter are confidential and our submission of the information below should in no way be construed as giving permission to you to release its contents without our prior permission.

Background

In order to gauge the full impact of the TARP capital injection on lending activity, a review of events leading up to funding is required. While our totals show modest net loan growth since the TARP funding, absent the TARP transaction, loan activity would have been sharply curtailed, and we believe the Company's outstanding loan balance would have been reduced significantly.

In late July 2008, we initiated a series of efforts to restrict and reduce lending and to identify loans within the Bank's portfolio which might be available for sale into secondary, private or independent bank markets. These actions were precipitated by the sudden national exposure of widespread loan losses suffered by a large number of domestic banks, the failure of IndyMac, the sudden collapse of bank stocks, and national press coverage of congressional hearings covering the subject.

The result of these events was a nationwide flight of deposits out of the banking system and into perceived higher quality investment vehicles. The Bank's deposits were likewise affected and our customer deposit base fell each successive month from \$1.018 billion on June 30, 2008 to \$966 million as of September 30, 2008, a 5.1% decrease. Over this same period, total loans grew \$41 million, or 3.4%, driving the Bank's loan to deposit ratio from 100.22% to 103.10% and forcing unusual dependence on brokered deposits to fund our lending activities. By mid-2008, a series of five initiatives had been launched to curtail lending activities and attempt to reduce the loan portfolio by \$35 to \$45 million. These initiatives are further discussed in Appendix A.

In addition to selling loans or participation in loans, the Company also explored alternatives for raising new capital. During the third quarter of 2008, the Company, in the course of its capital management process, concluded that it should strengthen its capital base by the end of 2008 to maintain its "well capitalized" status and meet the demands of its loan business. As of June 30, 2008, the Company had a Total Risk-based Capital Ratio of 10.01%. This ratio was within the "well capitalized" guideline of 10%. However, management realized that growth in the loan portfolio, coupled with anticipated stress due to a deteriorating economy, would require the Company to obtain additional capital to maintain its capital base or else continue with its plans to sell loans and restrict loan growth.

In September 2008, management met with an investment banking firm to discuss capital raising alternatives. The investment banking firm believed that based on the Company's financial capacity and market valuation, it could raise between \$20 million and \$30 million of new capital. Two different transactions were discussed. The first, a private placement of subordinate-debt and common stock warrants, was more desirable, but the investment bank advised that after selectively exploring this opportunity there were few parties interested in such structure. The second, a private investment/public equity (PIPE) issuance of common stock and noncumulative convertible preferred to institutional investors, was also discussed. However,

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because of the pricing being discussed, the transaction would have resulted in a significant adverse impact on earnings per share. Also during this period, the Company engaged in discussions with one of its institutional shareholders about an additional investment in the Company. The Company reviewed a preliminary term sheet for a private placement of common stock based on an issue price that would have been at a discount to the then current market price. Finally, the Company considered a possible rights offering to its shareholders, but such a transaction could not be completed before the end of 2008 due to corporate, SEC and regulatory requirements.

At the same time, the Company was exploring alternatives to strengthen its capital base, the Company was having on-going discussions with one of its correspondent banks regarding an outstanding unsecured line of credit that the correspondent bank had advanced to HCC. It became apparent to management as early as the end of the third quarter that the Company had to address its relationship with the correspondent bank. HCC had \$15 million outstanding under the line of credit at June 30, 2008. After several discussions with the correspondent bank, the line was renewed for a short period of time. During subsequent discussions/negotiations, it became apparent that the correspondent bank either wanted the line repaid in full; or, alternatively, partially repaid, with the smaller line to be renewed at a higher rate of interest, secured by liquid collateral and amortized over 5 years. Negotiations with the correspondent bank continued through February 2009.

Use of TARP Preferred Investment

In October 2008, Congress enacted the Emergency Economic Stabilization Act of 2008 ("EESA") and, shortly thereafter, the Treasury announced the Capital Purchase Program. HCC was an early participant in the program. On November 21, 2008, HCC issued \$40 million of preferred stock and common stock warrants to the Treasury. HCC has down-streamed \$20 million of the proceeds to the Bank. As a practical matter, we cannot differentiate which of the loans that we advanced or renewed after November 21, 2008 were directly funded by the TARP proceeds, the approximately \$79 million of common equity, the \$68 million retained earnings we hold or the approximately \$1.2 billion in deposits or other obligations that made up our balance sheet as of December 31, 2008. However, there is no question that after November 21, 2008, we began lending more with the TARP preferred stock investment than we would have loaned without it.

After committing to accept the TARP preferred stock investment, management immediately began freeing up funds to increase lending activity. From November 21, 2008 through December 31, 2008, we closed 67 new loans (\$31,537,281 in commitments) and renewed another 29 loans (\$45,942,257 in commitments) for a total of over \$77 million in new and renewed loans over a 5 week period.

By the close of November, loan totals had grown by \$11 million and by year end, outstanding loans had grown \$30 million, from \$1.219 billion to \$1.249 billion. Many of these

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loans had been in the pipeline for some time, and after working through the bulge in demand, our loan pipeline moved back to normal levels. As a result, loan activity continued throughout January, but at a slower pace. In January, the Bank made total loan commitments of \$23,606,357, representing \$9,549,291 in commitments for new loans and \$14,057,066 in renewed loans. In February of 2009, another \$37,637,396 in commitments for new and renewed loans was booked. Of these loans, \$11,618,217 represented new loans and \$26,019,179 represented renewals of existing loans.

We believe this lending activity would have been much lower without the TARP proceeds. As noted above, in view of the capital position of the Company, without taking actions to add capital, the Company was actually moving toward a program to sell loans and loan participations and reduce loan growth.

Of the remaining balance of \$20 million of TARP proceeds, \$15 million was used to repay all of our obligations under the line of credit with our correspondent bank. This action was taken only after a significant amount of further negotiations with the correspondent bank about possible restructuring of the line of credit, and discussions with the Boards of Directors of HCC and the Bank. We took this action to increase our liquidity and strengthen our capital position. By eliminating the line of credit, we created further flexibility for managing our capital at both the HCC and the Bank level. If the line of credit had remained outstanding, we would have had to either upstream more funds from the Bank over the life of the line of credit, thereby reducing capital at the Bank level, or refinance the indebtedness from a capital raising transaction. We have retained \$5 million of the remaining TARP proceeds at the HCC level.

(b) (4)

We would also like to bring to your attention that during 2008, HCC paid a cash dividend of \$0.32 per share, or \$0.08 per quarter. In 2009, we have announced a reduction in our cash dividend to \$0.02 for the fourth quarter of 2008. This reduction will save approximately \$2.8 million in capital on an annual basis.

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(b) (4)

Beyond loan growth, the TARP funds permitted the Bank to absorb the shock of additional deterioration of its loan portfolio. TARP funds provided the cushion to enable the Bank to recognize an additional \$56.2 million in classified loans, \$16.3 million in nonperforming loans and \$1.8 million in charge-offs between the third and fourth quarters of 2008 and still remain well capitalized. At December 31, 2008, our capital ratios were strong, with a Total Risk-based Capital Ratio of 13.11%.

Executive Compensation

We have not used TARP funds to pay compensation, bonuses or any other benefits to our management or staff. The HCC Board of Directors Compensation Committee (the members of whom meet the “independence” and all other requirements of the SEC and the NASDAQ Stock Market) reviews and assesses our senior management’s performance and has historically linked past compensation and incentive decisions to the performance of HCC and the Bank, both in terms of profitability and risk profile. Like most of our peers, the Company has historically paid modest salaries and annual bonuses linked to pre-established target performance. We have issued stock options over the years to senior management with the prior approval of our Compensation Committee. Our executive level officers have employment contracts with the Company that pre-date our participation in the TARP program. Although executive level officers were eligible for a bonus under our bonus incentive plan for 2008 performance based on our 2008 performance targets, the chief executive officer recommended, and our Compensation Committee determined, that bonuses would not be paid for 2008 performance and salaries would not be increased in 2009 for executive level officers.

Specifically, with regard to the requirements of the TARP program, the Company and its executive level officers took the following actions:

1. Each executive level officer signed a letter dated November 21, 2008, required by the Treasury, in which he “voluntarily waived any claim against the United States or [his] employer for any changes to [his] compensation or benefits that are required to comply with the regulation issued by the Department of the Treasury as published in the Federal Register on October 20, 2008” (“Treasury Regulation”).

2. Each executive level officer signed an amendment to his existing employment agreement dated December 29, 2008, that provides that as long as the U.S. Treasury owns any stock or assets of the Company pursuant to the Emergency Economic Stabilization Act of 2008 (“EESA”) or TARP, in the event that any payment or benefit received or to be received by the executive pursuant to the terms of the employment agreement or otherwise in connection with the executive’s termination of employment or contingent upon a change in ownership or control pursuant to any plan or arrangement or other agreement with the Company (or any affiliate) would constitute a “parachute payment” within the meaning of Section 2800(b)(2) of the Internal Revenue Code of 1986, as amended, including application of Section 2800(e) as added by EESA and any other applicable restrictions under EESA for the Company to comply with TARP, then the payments and benefits received or to be received by the executive would be reduced by the minimum extent necessary so that such payments and benefits did not constitute a “parachute payment”. These amendments were filed with the SEC on Form 8-K on January 2, 2009.

3. The Company’s Compensation Committee adopted a “claw-back” policy with respect to any bonuses paid under the Company’s bonus plan for executive level officers if the Company’s audit committee determines that a bonus paid under the plan was based when paid on

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financial statements or other financial metric criteria which were materially inaccurate. The bonus plan is established pursuant to the Company's Management Incentive Plan and the actual target measures will be determined when the Compensation Committee meets in March 2009. The policy is intended to comply with the Treasury Regulation.

4. Within 90 days following the preferred stock investment on November 21, 2008, the Company's Compensation Committee along with the risk managers of the Company (including its internal auditor, in-house general counsel, chief credit and risk officer, chief financial officer, chief executive officer of HCC and the president of the Bank) reviewed the incentive compensation and stock option plans of the Company to determine whether they encourage unreasonable risk-taking by the senior executives. After review, the Committee concluded that the plans do not encourage unreasonable risk-taking by senior executives. In addition, several provisions were added to the bonus incentive plan for executive level officers to further reduce incentives for unreasonable risk taking.

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The Company is aware that the American Recovery and Reinvestment Act of 2009 has amended or changed some of the requirements of EESA. As Department of Treasury guidelines regarding this legislation and, specifically, executive compensation, are finalized, you may be assured that the Company will make every effort to implement and comply with those limitations to the extent applicable to the Company.

Enclosed Information

For your review and in furtherance of the information provided above, we are enclosing the following:

Appendix A – Initiatives and Narrative of Steps Taken to Curtail Loan Activities Prior to November 21, 2008.

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The undersigned signing on behalf of Heritage Commerce Corp and Heritage Bank of Commerce certifies to the best of his knowledge that the statements, representations, and supporting information made in or accompanying this letter are accurate and that this certification is subject to the requirements and penalties set forth in Title 18, United States Code, Section 1001.

Heritage Commerce Corp

By: 

Lawrence D. McGovern
Executive Vice President
and Chief Financial Officer

Heritage Bank of Commerce

By: 

Lawrence D. McGovern
Executive Vice President
and Chief Financial Officer

Appendix A

Initiatives and Narrative of Steps Taken to Curtail Loan Activities Prior to November 21, 2008

By mid-2008, we had launched a series of five initiatives to curtail lending activities and attempt to shrink our loan portfolio by \$35 to \$45 million. These included:

1. Identification and pricing of “available for sale” SBA loans for potential liquidation into the secondary markets.
2. Identification, classification and pricing of commercial real estate loans which might be sold to institutional or private investors.
3. Identification of problem construction loans which might be sold at discount to intermediaries and/or institutional buyers.
4. Identification and classification of Commercial real estate loans which might be out-participated to local independent banks.
5. Stringent restrictions on all real estate lending to include both construction loans and mini-perms. Measures included significant price increases, more restrictive loan to value requirements, Executive Loan Committee approval of any real estate loan over \$1,000,000 and a curtailment of investor real estate mini-perm loans.

By September 2008, these collective measures began to have an impact on loan originations. The simple curtailment of new real estate lending halted portfolio growth and in the fourth week in September 2008, total loan outstandings had slowed and then peaked at \$1.255 billion. A slight contraction followed and by September 30, 2008, loans had leveled off at \$1.251 billion.

Capital ratios were barely above “well capitalized” and remained tight; also liquidity pressures had not substantially eased. As a result, management continued to pursue opportunities to liquidate existing loan portfolio. It was decided that selling SBA loans would provide insufficient capital relief due to the lower capital requirements on Section 7a loans. Additionally, secondary market yields were insufficient to cover costs of origination, so the Bank focused on selling real estate loans and dampening the extension of new credit.

On October 1, 2008, the Bank out-participated its first group of commercial real estate loans. Eleven loans totaling \$3,274,739 were sold to an independent California bank. The sale, in conjunction with continued restrictions on lending, reduced loan totals. By the October 15, 2008 loan totals had decreased to \$1.240 billion. Review of SBA loans for sale continued. However, because additional real estate loans were scheduled to be sold by month-end, management decided not to sell section 7a loans. On October 28, 2008, the second loan participation took place. Two loans totaling \$3.997 million were out-participated to another independent California bank and discussions continued with two other independent banks. By the end of October 2008, loan outstandings had decreased another \$9 million, with a balance at the end of October 2008 of \$1.231 billion.

Capital ratios had improved slightly by the end of October 2008, but continued at a level considered tight by management, with a Total Risk-based Capital Ratio of 10.34%. Liquidity remained an area of focus as it was tight, with a loan to deposit ratio of 105.25%. Accordingly, real estate and commercial lending were further restricted, with new loan consideration given primarily to existing borrowers. Clients with maturing mini-perms were encouraged to refinance elsewhere. By mid-November 2008, loans had contracted another \$17 million to \$1.214 billion.