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March 6, 2009

Mr. Neil M. Barofsky
Special Inspector General
Office of the Special Inspector General
Troubled Asset Relief Program
1500 Pennsylvania Ave., N.W., Suite 1064
Washington, D.C. 20220

Dear Mr. Barofsky:

I am responding to your request dated February 6, 2009, for the information regarding our treatment of the Troubled Asset Relief Program ("TARP") funds. Effective, November 21, 2008, Heritage Financial Corporation ("Company") entered into a contract with the U.S. Department of the Treasury ("Treasury") to participate in the Treasury's Capital Purchase Program ("CPP"), which was established by Treasury pursuant to the authority granted by the Emergency Economic Stabilization Act of 2008 (the "EESA"). The resulting effect of this transaction was that the Treasury invested \$24,000,000 in our Company in return for 24,000 shares of Fixed Rate Cumulative Perpetual Preferred Stock, Series A, with a related Warrant to purchase 276,074 shares of the Company's common stock. As the Treasury has stated, they are making investments into healthy, viable banks and in return receiving a cumulative dividend of 5% per annum on the preferred securities.

Effective February 17, 2009, President Obama signed into law the American Recovery and Reinvestment Act of 2009 ("ARRA"). The ARRA amends the provisions of the EESA that are applicable to Troubled Asset Relief Program ("TARP") recipients.

The following responses address your specific requests:

- (1) (a) Our anticipated use of the TARP funds is to allow the Company, which includes our two subsidiary banks, Heritage Bank and Central Valley Bank, the ability to lend to our community, work with our existing borrowers through these difficult times and provide our depositors of all sizes with security, which additional capital and liquidity allows us to do.

(b) The TARP funds were not segregated from other institutional funds. The funds were deposited into Heritage Bank's Federal Reserve Bank account. Similar to all bank deposits these funds are utilized to manage the bank's daily requirements to fund loans and return funds to depositors who require them.

(c) You've requested the use of TARP funds to date. However, we are providing you with information through December 31, 2008 as a result of our being a publicly traded company and our first quarter 2009 financials have not been made public. During the months of November and December, the Company originated a total of \$33 million in new loans to individuals and businesses in the communities we serve. In addition, we renewed a total of \$57 million in loans, keeping these dollars at work in our communities. We also injected capital into Heritage Bank increasing the bank's already "well capitalized" basis even further to ensure Heritage Bank's continued ability to make loans.

(d) We expect to continue to lend in our communities and sustain a solid balance sheet providing security to our depositors. To this end, we employ an experienced Small Business Administration ("SBA") lending officer, which has expanded our SBA lending activities. We have SBA's preferred lending status and consider ourselves as knowledgeable and experienced SBA lenders. We have also enhanced our SBA community out-reach programs meeting with many community organizations educating them on the various SBA programs available for new and existing customers. While we remain a TARP recipient we will track and publicly report our SBA lending activities as well as our outreach programs.

- (2) The Company has adhered to the executive compensation requirements required by EEAS and ARRA.

The Company was required to establish specific standards for incentive compensation programs for its senior executive officers and to make changes to its compensation arrangements as necessary to comply with the provisions of the EESA. The Secretary of the Treasury ("Secretary") is to establish standards for executive compensation which are to include "limits on senior executive compensation; provision for recovery of bonus, retention awards, or incentive compensation paid to a senior executive based on earnings, revenue, gains or other criteria later found to be materially inaccurate, which also includes the next 20 most highly compensated employees; prohibition of golden parachute payments to a senior executive officer or the next five most highly compensated employees; prohibition on paying or accruing any bonus, retention award, or incentive compensation – except long-term restricted stock is allowed if it does not fully vest while TARP funds remain unpaid, has a value of not greater than one-third of the total amount of annual compensation of the recipient, and is subject to other conditions the Secretary may determine to be in the public interest (since Heritage received less than \$25 million in TARP funds, this restriction applies only to Heritage's most highly compensated employee); prohibition of any compensation plan that would encourage manipulation of reported earnings of a

TARP recipient; and establishment of an independent compensation committee to review compensation plans, and that meets at least semi-annually to discuss and evaluate compensation plans in light of an assessment of any risk posed to the TARP recipient from such plans.” The ARRA defines “golden parachute payment” to mean “any payment to a senior executive officer for departure from a company for any reason, except for payments for services performed or benefits accrued.”

Because of the requirements of the ARRA, some of the Company’s compensation arrangements cannot be in effect as long as TARP funds are outstanding. The Compensation Committee will continue to review the plans to determine what changes will be required upon receipt of regulations issued by the Secretary.

Even prior to the implementation of EESA and ARRA, the Company has maintained a prudent incentive compensation plan and is not excessive in nature. In addition, our Company manages risks every day at many levels such as credit, operational and control risks inherent to our operations. We have not managed our analysis of our incentive payments much different post-TARP funds than we did prior to receiving TARP funds.

During the Compensation Committee meeting of the Board of Directors held on February 20, 2009, the Board approved the Compensation Discussion and Analysis as well as the full Compensation Committee Report as disclosed in our 2008 Proxy Statement. In addition, the board reviewed and approved executive compensation to ensure that the Senior Executive Officers incentive compensation arrangements do not encourage the Senior Executive Officers to take unnecessary and excessive risks that threaten the value of our Company.

Management is also in the process of holding Town Hall meetings for the purpose of addressing and answering any questions or concerns our customers or shareholders may have as it pertains to the CPP. We have attached a press release announcing these meetings. Management believes there has been much disinformation as it pertains to the CPP and feels it is important to help the public understand better why we chose to accept TARP funds and what we are doing with them. We have also invited many members of our local and regional press to attend. These Town Hall meetings are designed to be informative as well as an open dialogue with unlimited question and answer sessions. I will be personally conducting these sessions.

The CPP was a prudent step during these uncertain economic times. I believe that our employees, customers and investors should view this event as favorable and positive to their respective interests in the continuing successes of our Company. I encourage your department to take this opportunity to educate the public on this program, which is an investment made by the Treasury with an expected monetary return to the Treasury with value added to the financial system and our economy as a whole rather than what is commonly referred to as a “bailout” program.

Subject to the requirements and penalties of Title 18, United States Code, Section 1001, I hereby certify that the within statements, representations and supporting information are, to the best of my knowledge and belief, true and accurate in all material respects.

If you have any additional questions please feel free to contact me at (b) (6) [REDACTED]

Sincerely, (b) (6) [REDACTED]

(b) (6) [REDACTED]

Brian L. Vance
President and CEO
Heritage Financial Corporation



FOR IMMEDIATE RELEASE

DATE: March 6, 2009

**CONTACT: Brian L. Vance
President & CEO
(360) 943-1500**

**Heritage Bank Public Invitation:
CEO "Reports to our Communities"**

Heritage Bank, a subsidiary of Heritage Financial Corporation (Nasdaq: HFWA), today announced Brian Vance, President & CEO of Heritage Bank is giving informational "Reports to Our Communities" in Thurston, Pierce and Mason Counties. Each event will be held from 8:00 a.m. to 9:30 a.m. and will illustrate how Heritage Bank is managing the effects of market volatility and continuing to focus on the fundamentals of community banking, with strong liquidity, capital position, credit quality and earnings.

The following events are open to the public:

- Tuesday, March 10th – Masonic Center, 455 North St. SE, Tumwater
- Wednesday, March 11th – Pavilion at Sentry Park, 190 W Sentry Dr., Shelton
- Thursday, March 12th – Best Western Tacoma Dome Hotel, 2611 East E St., Tacoma
- Friday, March 20th – Mama Stortini's, 3207 E Main Ave., Puyallup

For more information regarding the above noted events, please call (800) 455-6126.

Heritage Financial Corporation is a bank holding company headquartered in Olympia, Washington. The Company operates two community banks, Heritage Bank and Central Valley Bank. Heritage Bank serves Pierce, Thurston, south King and Mason Counties in the south Puget Sound region of Washington through its fourteen full-service banking offices and its Online Banking Website www.HeritageBankWA.com. Central Valley Bank serves Yakima and Kittitas Counties in central Washington through its six full-service banking offices and its Online Banking Website www.CVBankWA.com. Additional information about Heritage Financial Corporation is available on its Internet Website www.HF-WA.com. Additional information about Heritage Financial Corporation is available on its Internet Website www.HF-WA.com.