HERITAGE COMMERCE CORP
Form 10-Q
May 09, 2008

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

FORM 10-Q

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

For the quarterly period ended March 31, 2008

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)

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 reports), and (2) has been subject to such filing requirements for the past 90 days. YES [X] NO [ ]

Indicate by check mark whether the Registrant is a 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. (Check one):
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 Exchange Act). YES [ ] NO [X]

The Registrant had 12,010,165 shares of Common Stock outstanding on April 18, 2008.

Heritage Commerce Corp and Subsidiaries
Quarterly Report on Form 10-Q
Table of Contents

1

Part I -- FINANCIAL INFORMATION

ITEM 1 - CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Heritage Commerce Corp
Consolidated Balance Sheets (Unaudited)

		March 31, 2008		December 31, 2007
		(Dollars in thousands)		
Assets				
Cash and due from banks	$	28,356	$	39,793
Federal funds sold		100		9,300
Total cash and cash equivalents		28,456		49,093
Securities available-for-sale, at fair value		130,784		135,402
Loans, net of deferred costs		1,131,805		1,036,465
Allowance for loan losses		(13,434)		(12,218)
Loans, net		1,118,371		1,024,247
Federal Home Loan Bank and Federal Reserve Bank stock, at cost		7,141		7,002
Company owned life insurance		39,402		38,643
Premises and equipment, net		9,193		9,308
Goodwill		43,181		43,181
Intangible Assets		4,760		4,972
Accrued interest receivable and other assets		33,439		35,624
Total assets	$	1,414,727	$	1,347,472
Liabilities and Shareholders' Equity				
Liabilities:				
Deposits				
Demand, noninterest bearing	$	254,938	$	268,005
Demand, interest bearing		159,046		150,527
Savings and money market		494,912		432,293
Time deposits, under $100		35,095		34,092
Time deposits, $100 and over		161,840		139,562
Brokered deposits		65,873		39,747
Total deposits		1,171,704		1,064,226
Notes payable to subsidiary grantor trusts		23,702		23,702
Securities sold under agreement to repurchase		35,900		10,900
Other short-term borrowings		5,000		60,000
Accrued interest payable and other liabilities		25,649		23,820
Total liabilities		1,261,955		1,182,648
Commitments and contingencies (note 7)				
Shareholders' equity:				
Preferred stock, no par value; 10,000,000 shares authorized; none outstanding		-		-
Common Stock, no par value; 30,000,000 shares authorized; shares outstanding: 12,170,346 at March 31, 2008 and 12,774,926 at December 31, 2007		82,120		92,414

Retained earnings		70,797		73,298
Accumulated other comprehensive loss		(145)		(888)
Total shareholders' equity		152,772		164,824
Total liabilities and shareholders' equity	$	1,414,727	$	1,347,472

See notes to consolidated financial statements

Heritage Commerce Corp
Consolidated Income Statements (Unaudited)

	Three Months Ended March 31, 2008	Three Months Ended March 31, 2007
	(Dollars in thousands, except per share data)	
Interest income:		
Loans, including fees	$ 18,355	$ 14,670
Securities, taxable	1,477	1,909
Securities, non-taxable	24	44
Interest bearing deposits in other financial institutions	7	32
Federal funds sold	32	579
Total interest income	19,895	17,234
Interest expense:		
Deposits	5,717	4,785
Notes payable to subsidiary grantor trusts	557	581
Repurchase agreements	156	137
Other short-term borrowings	361	-
Total interest expense	6,791	5,503
Net interest income	13,104	11,731
Provision for loan losses	1,650	(236)
Net interest income after provision for loan losses	11,454	11,967
Noninterest income:		
Gain on sale of SBA loans	-	1,011
Servicing income	479	517
Increase in cash surrender value of life insurance	398	345
Service charges and fees on deposit accounts	415	274
Other	222	368
Total noninterest income	1,514	2,515
Noninterest expense:		
Salaries and employee benefits	6,059	4,888
Occupancy	902	765
Professional fees	665	337
Low income housing investment losses and writedowns	210	237
Client services	224	230
Advertising and promotion	180	212
Data processing	245	203
Furniture and equipment	217	110
Retirement plan expense	53	61
Amortization of intangible assets	212	-
Other	1,613	1,257
Total noninterest expense	10,580	8,300
Income before income taxes	2,388	6,182
Income tax expense	684	2,149
Net income	$ 1,704	$ 4,033
Earnings per share:		
Basic	$ 0.14	$ 0.35

Diluted	$	0.14	$	0.34

See notes to consolidated financial statements

3

Heritage Commerce Corp
Consolidated Statements of Shareholders' Equity (Unaudited)
Three Months Ended March 31, 2008 and 2007

	Common Stock Shares	Amount	Retained Earnings	Accumlated Other Comprehensive Loss	Total Shareholders' Equity	Comprehensive Income
	(Dollars in thousands, except share data)					
Balance, January 1, 2007	11,656,943	$ 62,363	$ 62,452	$ (1,995	$ 122,820	
Net Income	-	-	4,033	-	4,033	$ 4,033
Net change in unrealized gain on securities available-for-sale and Interest-Only strips, net of reclassification adjustment and deferred income tax	-	-	-	268	268	268
Decrease in pension liability, net of deferred income tax	-	-	-	15	15	15
Total comprehensive income						$ 4,316
Amortization of restricted stock award	-	38	-	-	38	
Dividend declared on commom stock, $0.06 per share	-	-	(699)	-	(699)	
Commom stock repurchased	(35,000)	(892)	-	-	(892)	
Stock option expense	-	215	-	-	215	
Stock options exercised, including related tax benefits of $78	14,885	234	-	-	234	
Balance, March 31, 2007	11,636,828	$ 61,958	$ 65,786	$ (1,712	$ 126,032	
Balance, January 1, 2008	12,774,926	$ 92,414	$ 73,298	$ (888)	$ 164,824	
Cumulative effect adjustment upon adoption of EITF 06-4, net of deferred income taxes	-	-	(3,182)	-	(3,182)	
Net Income	-	-	1,704	-	1,704	$ 1,704
Net change in unrealized gain on securities available-for-sale and Interest-Only strips, net of reclassification adjustment and deferred income tax	-	-	-	729	729	729
Decrease in pension liability, net of deferred income tax	-	-	-	14	14	14
Total comprehensive income						$ 2,447
	-	38	-	-	38	

Amortization of restricted stock award										
Dividend declared on commom stock, $0.08 per share	-		-		(1,023)		-		(1,023)
Commom stock repurchased	(613,362)		(10,765)		-		-		(10,765)
Stock option expense	-		342		-		-		342
Stock options exercised, including related tax benefits of $10	8,782		91		-		-		91
Balance, March 31, 2008	12,170,346	$	82,120	$	70,797	$	(145)	$	152,772

See notes to consolidated financial statements

Heritage Commerce Corp
Consolidated Statements of Cash Flows (Unaudited)

	Three Months Ended March 31,	
	2008	2007
	(Dollars in thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 1,704	$ 4,033
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	231	150
Provision for loan losses	1,650	(236)
Stock option expense	342	215
Amortization of intangible assets	212	-
Amortization of restricted stock award	38	38
Amortization of discounts and premiums on securities	67	77
Gain on sale of SBA loans	-	(1,011)
Proceeds from sales of SBA loans held for sale	-	19,849
Change in SBA loans held for sale	-	(9,953)
Increase in cash surrender value of life insurance	(398)	(344)
Effect of changes in:		
Accrued interest receivable and other assets	4,027	2,960
Accrued interest payable and other liabilities	(3,633)	137
Net cash provided by operating activities	4,240	15,915
CASH FLOWS FROM INVESTING ACTIVITIES:		
Net change in loans	(95,774)	21,656
Purchases of securities available-for-sale	(7,141)	(2,295)
Maturities/paydowns/calls of securities available-for-sale	12,872	10,340
Purchase of life insurance	(361)	-
Purchase of premises and equipment	(116)	(57)
Purchase of Federal Home Loan Bank stock	(138)	(73)
Net cash provided by (used in) investing activities	(90,658)	29,571
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net change in deposits	107,478	37,304
Exercise of stock options	91	234
Common stock repurchased	(10,765)	(892)
Payment of dividends	(1,023)	(699)
Net change in other short-term borrowings	(55,000)	-
Net change in securities sold under agreement to repurchase	25,000	(6,700)
Net cash provided by financing activities	65,781	29,247
Net increase (decrease) in cash and cash equivalents	(20,637)	74,733
Cash and cash equivalents, beginning of period	49,093	49,385
Cash and cash equivalents, end of period	$ 28,456	$ 124,118
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	$ 7,057	$ 6,050
Income taxes	$ -	$ -

Supplemental schedule of non-cash investing activity:				
Transfer of portfolio loans to loans held for sale	$	-	$	972

See notes to consolidated financial statements

HERITAGE COMMERCE CORP
Notes to Consolidated Financial Statements
March 31, 2008
(Unaudited)

1) Basis of Presentation

The unaudited consolidated financial statements of Heritage Commerce Corp (the "Company") and its wholly owned subsidiary, Heritage Bank of Commerce ("HBC"), have been prepared pursuant to the rules and regulations for reporting on Form 10-Q. Accordingly, certain information and notes required by accounting principles generally accepted in the United States of America ("GAAP") for annual financial statements are not included herein. The interim statements should be read in conjunction with the consolidated financial statements and notes that were included in the Company's Form 10-K for the year ended December 31, 2007. The Company has also established the following unconsolidated subsidiary grantor trusts: Heritage Capital Trust I; Heritage Statutory Trust I; Heritage Statutory Trust II; and Heritage Commerce Corp Statutory Trust III which are Delaware Statutory business trusts formed for the exclusive purpose of issuing and selling trust preferred securities. On June 20, 2007, the Company completed its acquisition of Diablo Valley Bank ("DVB"). DVB was merged into HBC at the acquisition date.

HBC is a commercial bank serving customers located in Santa Clara, Alameda, and Contra Costa counties of California. No customer accounts for more than 10 percent of revenue for HBC or the Company. Management evaluates the Company's performance as a whole and does not allocate resources based on the performance of different lending or transaction activities. Accordingly, the Company and its subsidiary operate as one business segment.

In the Company's opinion, all adjustments necessary for a fair presentation of these consolidated financial statements have been included and are of a normal and recurring nature. All intercompany transactions and balances have been eliminated.

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

The results for the three months ended March 31, 2008 are not necessarily indicative of the results expected for any subsequent period or for the entire year ending December 31, 2008.

Adoption of New Accounting Standards

In September 2006, the Financial Accounting Standard Board ("FASB") Emerging Issues Task Force ("EITF") finalized 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. The required accrued liability will be based on either the post-employment benefit cost for the continuing life insurance or the future death benefit depending on the contractual terms of the underlying agreement. The Company adopted EITF 06-4 on January 1, 2008. The adoption of EITF 06-4 resulted in a cumulative effect adjustment to retained earnings of $3.2 million, net of deferred taxes, at January 1, 2008. For the first quarter of 2008, the adoption of EITF 06-4 resulted in noninterest expense of $130,000, and it is anticipated that related noninterest expense for 2008 will be approximately $578,000. Under the prior accounting method used by management, the Company recorded noninterest expense of $28,000 in the first quarter of 2007 and $194,000 for the year ended December 31, 2007.

In September 2006, FASB issued Statement 157, Fair Value Measurements. This Statement defines fair value, establishes a framework for measuring fair value in GAAP, and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements, FASB having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. In February 2008, the FASB issued Staff Position ("FSP") 157-2, "Effective Date of FASB Statement No. 157." This FSP delays the effective date of FAS 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value on a recurring basis (at least annually) to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years. The Company adopted this accounting standard on January 1, 2008. Except for additional disclosures in the notes to the financial statements, adoption of Statement 157 has not impacted the Company.

In February 2007, FASB issued Statement 159, The Fair Value Option for Financial Assets and Financial Liabilities. This statement provides companies with an option to report selected financial assets and liabilities at fair value. The Standard's objective is to reduce both complexity in accounting for financial instruments and the volatility in earnings caused by measuring related assets and liabilities differently. The standard requires companies to provide additional information that will help investors and other users of financial statements to more easily understand the effect of the company's choice to use fair value on its earnings. It also requires entities to display the fair value of those assets and liabilities for which the company has chosen to use fair value on the face of the balance sheet. Statement 159 does not eliminate disclosure requirements included in other accounting standards, including requirements for disclosures about fair value measurements included in Statements 157, Fair Value Measurements, and 107, Disclosures about Fair Value of Financial Instruments. This Statement is effective for the Company as of January 1, 2008. The Company did not elect the fair value option for any financial instruments.

On November 5, 2007, the Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin No. 109, Written Loan Commitments Recorded at Fair Value through Earnings ("SAB 109"). Previously, Staff Accounting Bulletin 105, Application of Accounting Principles to Loan Commitments ("SAB 105"), stated that in measuring the fair value of a loan commitment, a company should not incorporate the expected net future cash flows related to the associated servicing of the loan. SAB 109 supersedes SAB 105 and indicates that the expected net future cash flows related to the associated servicing of the loan should be included in measuring fair value for all written loan commitments that are accounted for at fair value through earnings. SAB 105 also indicated that internally-developed intangible assets should not be recorded as part of the fair value of a derivative loan commitment, and SAB 109 retains that view. SAB 109 is effective for derivative loans commitments issued or modified in fiscal quarters beginning after December 15, 2007. The adoption of this standard did not have a material impact on the Company's financial statements.

Newly Issued, but not yet Effective Accounting Standards

In March 2008, FASB issued Statement 161, Disclosures about Derivative Instruments and Hedging Activities - an Amendment of FASB Statement No. 133. This statement changes the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under Statement 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. This Statement is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. The adoption of this standard is not expected to have a material impact on the Company's financial statements.

In December 2007, FASB issued Statement 160, Noncontrolling Interests in Consolidated Financial Statements. This statement is intended to improve the relevance, comparability, and transparency of the financial information that a reporting entity provides in its consolidated financial statements by establishing accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. This Statement will be effective for fiscal years and interim periods within those fiscal years beginning on or after December 15, 2008. Management has not completed its evaluation of the impact, if any, of adopting Statement 160.

2) Securities Available-for-Sale

Securities with unrealized losses, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, are as follows at March 31, 2008:

	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
			(Dollars in thousands)			
U.S. Treasury	$ 2,020	$ (1)	$ -	$ -	$ 2,020	$ (1)
U.S. Government Sponsored Entities	-	-	-	-	-	-
Mortgage-Backed Securities	7,548	(44)	40,078	(633)	47,626	(677)
Municipals - Tax Exempt	1,412	-	-	-	1,412	-
Collateralized Mortgage Obligations	-	-	2,463	(19)	2,463	(19)
Total	$ 10,980	$ (45)	$ 42,541	$ (652)	$ 53,521	$ (697)

As of March 31, 2008, the Company held 77 securities, of which 17 had fair values below amortized cost. Ten securities have been carried with an unrealized loss for over 12 months. Unrealized losses were primarily due to higher interest rates. No security sustained a downgrade in credit rating. The issuers are of high credit quality and all principal amounts are expected to be paid when securities mature. The fair value is expected to recover as the securities approach their maturity date and/or market rates decline. Because the Company has the ability and intent to hold these securities until a recovery of fair value, which may be maturity, the Company does not consider these securities to be other-than-temporarily impaired at March 31, 2008.

Securities with fair value of $81,877,000, $41,626,000, and $50,394,000 as of March 31, 2008, December 31, and March 31, 2007 were pledged to secure public and certain other deposits as required by law or contract and other contractual obligations, respectively. A portion of these deposits can only be secured by U.S. Treasury securities. The Company has not used interest rate swaps or other derivative instruments to hedge fixed rate loans or to otherwise mitigate interest rate risk.

3) Stock-Based Compensation

The Company has a stock option plan (the “Option Plan”) for directors, officers, and key employees. The Option Plan provides for the grant of incentive and non-qualified stock options. The Option Plan provides that the option price for both incentive and non-qualified stock options will be determined by the Board of Directors at no less than the fair value at the date of grant. Options granted vest on a schedule determined by the Board of Directors at the time of grant. Generally, options vest over four years. All options expire no later than ten years from the date of grant. As of March 31, 2008, there are 86,233 shares available for future grants under the Option Plan. Option activity under the Option Plan is as follows:

Total Stock Options	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value
Options Outstanding at January 1, 2008	1,010,662	$ 19.02		
Granted	3,000	$ 18.39		
Exercised	(8,782)	$ 9.24		
Forfeited or expired	(16,099)	$ 20.75		
Options Outstanding at March 31, 2008	988,781	$ 19.07	7.3	$ 2,015,000
Vested or expected to vest	949,230	$ 19.07	7.3	$ 2,651,000
Exercisable at March 31, 2008	533,289	$ 16.60	6.1	$ 1,778,000

As of March 31, 2008, there was $3.2 million of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the Company's Option Plan. That cost is expected to be recognized over a weighted-average period of approximately 2.7 years.

The following table presents the assumptions used to estimate the fair value of options granted during the three month periods ending March 31, 2008 and 2007, respectively:

	2008	2007
Expected life in months (1)	72	72
Volatility (1)	23%	20%
Risk-free interest rate (2)	3.00%	4.71%
Expected dividends (3)	1.74%	0.88%

(1) Estimate based on historical experience. Volatility is based on the historical volatility of the stock over the most recent period that is generally commensurate with the expected life of the option.
(2) Based on the U.S. Treasury constant maturity interest rate with a term consistent with the expected life of the options granted.
(3) The Company began paying cash dividends on common stock in 2006. Each grant's dividend yield is calculated by annualizing the most recent quarterly cash dividend and dividing that amount by the market price of the Company's common stock as of the grant date.

The Company estimates the impact of forfeitures based on the Company's historical experience with previously granted stock options in determining stock option expense. The Company issues new shares of common stock to satisfy stock option exercises.

The Company awarded 51,000 restricted shares of common stock to Walter T. Kaczmarek, President and Chief Executive Officer of the Company, pursuant to the terms of a Restricted Stock Agreement dated March 17, 2005. The grant price was $18.15. Under the terms of the Restricted Stock Agreement, the restricted shares vest 25% per year at the end of years three, four, five and six, provided Mr. Kaczmarek is still with the Company, subject to accelerated vesting upon a change of control, termination without cause, termination by the executive officer for good reason (as defined by the executive employment agreement), death or disability. On March 17, 2008, 12,750 shares became vested. The fair value of the stock award at the grant date was $926,000, which is being amortized to expense over the six-year vesting period on the straight-line method. Amortization expense for the three months ended March 31, 2008 and 2007 was $38,000.

4) Earnings Per Share

Basic earnings per share is computed by dividing net income by the weighted average common shares outstanding. Diluted earnings per share reflects potential dilution from outstanding stock options, using the treasury stock method. There were 762,341 and 220,946 stock options for three months ended March 31, 2008 and 2007, respectively, considered to be antidilutive and excluded from the computation of diluted earnings per share. For each of the periods presented, net income is the same for basic and diluted earnings per share. Reconciliation of weighted average shares used in computing basic and diluted earnings per share is as follows:

	Three Months Ended March 31, 2008	
	2008	2007
Weighted average common shares outstanding - used in computing basic earnings per share	12,481,141	11,602,120
Dilutive effect of stock options outstanding, using the treasury stock method	76,362	218,515
Shares used in computing diluted earnings per share	12,557,503	11,820,635

5) Comprehensive Income

Comprehensive income includes net income and other comprehensive income, which represents the changes in net assets during the period from non-owner sources. The Company's sources of other comprehensive income are unrealized gains and losses on securities available-for-sale and Interest Only ("I/O") strips, which are treated like available-for-sale securities, and the liability related to the Company's supplemental retirement plan. The items in other comprehensive income are presented net of deferred income tax effects. Reclassification adjustments result from gains or losses on securities that were realized and included in net income of the current period that also had been included in other comprehensive income as unrealized gains and losses. The Company's comprehensive income follows:

	Three Months Ended March 31,	
	2008	2007
	(Dollars in thousands)	
Net Income	$ 1,704	$ 4,033
Other comprehensive income:		
Unrealized gains on available-for-sale of securities and I/O strips during the period	1,257	462
Deferred income tax	(528)	(194)
Net unrealized gains on available-for-sale securities and I/O strips, net of deferred income tax	729	268
Pension liability adjustment during the period	24	26
Deferred income tax	(10)	(11)
Pension liability adjustment, net of deferred income tax	14	15
Other comprehensive income	743	283
Comprehensive income	$ 2,447	$ 4,316

6) Supplementatal Retirement Plan

The Company has a supplemental retirement plan covering current and former key executives and directors. The Plan is a nonqualified defined benefit plan. Benefits are unsecured as there are no Plan assets. The following table resents the amount of periodic cost recognized for the three months ended March 31, 2008 and 2007:

	Three Months Ended March 31, 2008	Three Months Ended March 31, 2007
	(Dollars in thousands)	
Components of net periodic benefits cost		
Service cost	$ 203	$ 184
Interest cost	182	155
Prior service cost	9	9
Amortization of loss	14	17
Net periodic cost	$ 408	$ 365

9

7) Commitments and Contingencies

Financial Instruments with Off-Balance Sheet Risk

HBC is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its clients. These financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk, in excess of the amounts recognized in the balance sheets. The face amount of these items represents the exposure to loss, before considering customer collateral or ability to repay.

HBC uses the same credit policies in making commitments and conditional obligations as it does for loans. HBC controls the credit risk of these transactions through credit approvals, limits, and monitoring procedures. Management does not anticipate any significant losses as a result of these transactions.

Commitments to extend credit as of March 31, 2008 and December 31, 2007 were as follows:

	March 31, 2008	December 31, 2007
	(Dollars in thousands)	
Commitments to extend credit	$ 484,812	$ 444,172
Standby letters of credit	5,255	21,143
	$ 490,067	$ 465,315

Generally, commitments to extend credit as of March 31, 2008 are at variable rates, typically based on the prime rate (with a margin). Commitments generally expire within one year.

Since some of the commitments are expected to expire without being drawn upon, the total commitment amount does not necessarily represent future cash requirements. HBC evaluates each client's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by HBC upon the extension of credit, is based on management's credit evaluation of the borrower. Collateral held varies but may include cash, marketable securities, accounts receivable, inventory, property, plant and equipment, income-producing commercial properties, and/or residential properties.

Standby letters of credit are written with conditional commitments issued by HBC to guarantee the performance of a client to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to clients.

8) Fair Value

Statement 157 establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

Level 1: Quoted prices (unadjusted) or identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3: Significant unobservable inputs that reflect a reporting entity's own suppositions about the assumptions that market participants would use in pricing an asset or liability.

The fair values of securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges (Level 1 inputs) or matrix pricing, which is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities' relationship to other benchmark quoted securities (Level 2 inputs).

The fair value of I/O strip receivable assets is based on a valuation model used by an independent appraiser. The Company is able to compare the valuation model inputs and results to widely available published industry data for reasonableness (Level 2 inputs).

Assets and Liabilities Measured on a Recurring Basis

		Fair Value Measurements at March 31, 2008 Using		
	March 31, 2008	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Obeservable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
		(Dollars in thousands)		
Assets:				
Available for sale securities	$ 130,784	$ 12,173	$ 118,611	$ -
I/O strip receivables	$ 2,247	$ -	$ 2,247	$ -

Assets and Liabilities Measured on a Recurring Basis

	Fair Value Measurements at March 31, 2008 Using		
March 31, 2008	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Obeservable Inputs	Significant Unobservable Inputs