HERITAGE FINANCIAL CORP /WA/
Form 10-K
March 11, 2015
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2014
OR
.. TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
Commission File Number 0-29480

HERITAGE FINANCIAL CORPORATION
(Exact name of registrant as specified in its charter)

Washington (State or other jurisdiction of incorporation or organization)	91-1857900 (I.R.S. Employer Identification No.)
201 Fifth Avenue SW, Olympia, WA (Address of principal executive offices)	98501 (Zip Code)

(360) 943-1500
(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	NASDAQ Stock Market LLC

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 ý
Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No ý
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 ý No ¨
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T

(§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ý No ¨
Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.
Large accelerated filer ¨ Accelerated filer ý 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 ý
The aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant as of June 30, 2014, based on the closing price of its common stock on such date, on the NSADAQ Global Select Market, of $16.09 per share, and 29,423,514 shares held by non-affiliates was $473,242,340.
The registrant had 30,257,691 shares of common stock outstanding as of February 25, 2015.
DOCUMENTS INCORPORATED BY REFERENCE
Portions of the registrant's definitive Proxy Statement for the 2015 Annual Meeting of Shareholders will be incorporated by reference into Part III of this Form 10-K.

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FORM 10-K
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PART I

ITEM 1. BUSINESS

General

Heritage Financial Corporation (the “Company” or "Heritage") is a bank holding company that was incorporated in the State of Washington in August 1997. We were organized for the purpose of acquiring all of the capital stock of Heritage Savings Bank upon our reorganization from a mutual holding company form of organization to a stock holding company form of organization. Effective September 1, 2004, Heritage Savings Bank switched its charter from a state chartered savings bank to a state chartered commercial bank and changed its legal name from Heritage Savings Bank to Heritage Bank (the "Bank"). Effective September 1, 2005, Central Valley Bank (acquired by the Company in March 1999) changed its charter from a nationally chartered commercial bank to a state chartered commercial bank. In 1998, the Company acquired North Pacific Bank. In June 2006, the Company completed the acquisition of Western Washington Bancorp and its wholly owned subsidiary, Washington State Bank, N.A., at which time Washington State Bank, N.A. was merged into Heritage Bank.

Effective July 30, 2010, Heritage Bank entered into a definitive agreement with the Federal Deposit Insurance Corporation (the “FDIC”), pursuant to which Heritage Bank acquired certain assets and assumed certain liabilities of Cowlitz Bank, a Washington state-chartered commercial bank headquartered in Longview, Washington (the “Cowlitz Acquisition”). The Cowlitz Acquisition included nine branches of Cowlitz Bank, including its division Bay Bank, which opened as branches of Heritage Bank on August 2, 2010. The acquisition also included the Trust Services Division of Cowlitz Bank. In 2013, the Company consolidated three of these branches into existing Heritage Bank branches. Effective November 5, 2010, Heritage Bank entered into a definitive agreement with the FDIC, pursuant to which Heritage Bank acquired certain assets and assumed certain liabilities of Pierce Commercial Bank, a Washington state-chartered commercial bank headquartered in Tacoma, Washington (the “Pierce Acquisition”). The Pierce Acquisition included one branch, which opened as a branch of Heritage Bank on November 8, 2010.

On September 14, 2012, the Company announced that it had entered into a definitive agreement along with Heritage Bank, to acquire Northwest Commercial Bank (“NCB”), a full service commercial bank headquartered in Lakewood, Washington that operated two branch locations in Washington State (the “NCB Acquisition”). The NCB Acquisition was completed on January 9, 2013, at which time NCB was merged with and into Heritage Bank. The Lakewood branch was subsequently consolidated with an existing Heritage Bank branch in 2013. On March 11, 2013, the Company entered into a definitive agreement to acquire Valley Community Bancshares, Inc. ("Valley" or "Valley Community Bancshares") and its wholly-owned subsidiary, Valley Bank, both headquartered in Puyallup, Washington (the “Valley Acquisition”) and its eight branches. The Valley Acquisition was completed on July 15, 2013. Subsequently, four of these branches were consolidated into existing branches as of December 31, 2013. See Note 2 - Business Combinations of the Notes to Consolidated Financial Statements included in "Item 8. Financial Statements and Supplementary Data" for these acquisitions which closed during fiscal year 2013.

On April 8, 2013, the Company announced the proposed merger of its two wholly-owned bank subsidiaries Central Valley Bank and Heritage Bank, with Central Valley Bank merging into Heritage Bank (the "Central Valley Merger"). The common control merger was completed on June 19, 2013. Central Valley Bank now operates as a division of Heritage Bank.

On October 23, 2013, the Company, along with the Bank, and Washington Banking Company (“Washington Banking”) and its wholly owned subsidiary bank, Whidbey Island Bank ("Whidbey"), jointly announced the signing of a merger agreement pursuant to which Heritage and Washington Banking entered into a strategic merger with Washington Banking merging into Heritage (the "Washington Banking Merger"). Washington Banking branches adopted the Heritage Bank name in all markets, with the exception of six branches in Whidbey Island markets which continued to operate using the Whidbey Island Bank name. The Washington Banking Merger was completed on May 1, 2014. For additional information on the Washington Banking Merger, see Note 2 - Business Combinations of the Notes to Consolidated Financial Statements included in "Item 8. Financial Statements and Supplementary Data."

We are primarily engaged in the business of planning, directing, and coordinating the business activities of our wholly owned subsidiary, Heritage Bank. The deposits of the Bank are insured by the FDIC. Heritage Bank is headquartered in Olympia, Washington and conducts business in its sixty-six branch offices located in Washington and the greater Portland, Oregon area.

Our business consists primarily of lending and deposit relationships with small businesses and their owners in our market areas, and attracting deposits from the general public. We also make real estate construction and land development loans and consumer loans. The Bank also originates for sale or investment purposes one-to-four family

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residential loans on residential properties located primarily in western and central Washington State and the greater Portland, Oregon area.

Market Areas

We offer financial services to meet the needs of the communities we serve through our community-oriented financial institutions. Headquartered in Olympia, Thurston County, Washington, we conduct business through Heritage Bank and its sixty-six branch offices located along the I-5 corridor throughout Washington and the greater Portland, Oregon area. We additionally have offices located in eastern Washington, primarily in Yakima county.

Lending Activities

General.   Lending activities are conducted through Heritage Bank. Our focus is on commercial business lending. We also originate consumer loans, real estate construction and land development loans and one-to-four family residential loans. Our loans are originated under policies that are reviewed and approved annually by our Board of Directors. In addition, we have established internal lending guidelines that are updated as needed. These policies and guidelines address underwriting standards, structure and rate considerations, and compliance with laws, regulations and internal lending limits. We conduct post-approval reviews on selected loans and routinely perform internal loan reviews of our loan portfolio to check for credit quality, proper documentation and compliance with laws and regulations.

The Company has also acquired loans through mergers and acquisitions, which are designated as "purchased" loans. Purchased loans which are covered under FDIC shared-loss agreements are identified as "covered", while purchased loans not subject to FDIC shared-loss agreements as well as loans originated by the Company are referred to as "noncovered."

Noncovered commercial and industrial loans, including owner occupied commercial real estate loans, totaled $1.09 billion, or 51.2% of total noncovered loans, as of December 31, 2014, and $617.8 million, or 52.9% of total noncovered loans, as of December 31, 2013 and non-owner occupied commercial real estate loans totaled $616.8 million, or 29.0%, as of December 31, 2014 and $400.0 million, or 34.2% of total noncovered loans, as of December 31, 2013. One-to-four family residential loans totaled $63.5 million, or 3.0% of total noncovered loans, at December 31, 2014, and $43.1 million, or 3.7% of total noncovered loans, at December 31, 2013. Real estate construction and land development loans totaled $108.1 million, or 5.1% of total noncovered loans, at December 31, 2014, and $68.4 million, or 5.9% of total noncovered loans, at December 31, 2013.

Covered loans totaled $126.2 million and $63.8 million at December 31, 2014 and 2013, respectively. The majority of the covered loans are commercial and industrial loans, including owner occupied commercial real estate loans, totaling $78.4 million, or 62.1% of total covered loans, as of December 31, 2014, and $39.1 million, or 61.3% of total covered loans, as of December 31, 2013 and non-owner occupied commercial real estate totaled $26.9 million, or 21.3%, as of December 31, 2014 and $14.6 million, or 22.9% of total noncovered loans, as of December 31, 2013.

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The following table provides information about our noncovered loan portfolio by type of loan at the dates indicated. These balances are prior to deduction for the allowance for loan losses.

	December 31,									
	2014		2013		2012		2011		2010	
	Balance	% of Total (4)	Balance	% of Total (4)	Balance	% of Total (4)	Balance	% of Total (4)	Balance	% of Total (4)
	(Dollars in thousands)									
Noncovered loans:										
Commercial business:										
Commercial and industrial(1)	$1,087,085	51.2 %	$617,849	52.9 %	$503,708	53.7 %	$493,130	53.3 %	$470,116	53.9 %
Non-owner occupied commercial real estate	616,757	29.0	399,979	34.2	276,854	29.5	263,882	28.5	240,174	27.5
Total commercial business	1,703,842	80.2	1,017,828	87.1	780,562	83.2	757,012	81.8	710,290	81.4
One-to-four family residential(2)	63,540	3.0	43,082	3.7	41,888	4.5	40,703	4.4	52,491	6.0
Real estate construction and land development:										
One-to-four family residential	46,749	2.2	19,724	1.7	25,688	2.7	23,750	2.5	33,193	3.8
Five or more family residential and commercial properties	61,360	2.9	48,655	4.2	52,939	5.6	56,032	6.1	29,832	3.4
Total real estate construction and land development(3)	108,109	5.1	68,379	5.9	78,627	8.3	79,782	8.6	63,025	7.2
Consumer	250,323	11.8	41,547	3.5	39,627	4.2	50,401	5.4	48,585	5.6
Gross noncovered loans	2,125,814	100.1	1,170,836	100.2	940,704	100.2	927,898	100.2	874,391	100.2
Less: deferred loan fees	(937)	(0.1)	(2,670)	(0.2)	(2,096)	(0.2)	(1,860)	(0.2)	(1,323)	(0.2)
Total noncovered	$2,124,877	100.0%	$1,168,166	100.0 %	$938,608	100.0 %	$926,038	100.0 %	$873,068	100.0 %

loans

(1) Commercial and industrial loans include owner-occupied commercial real estate loans.

(2) Excludes loans held for sale of $5.6 million, $1.7 million, $1.8 million and $764,000 as of December 31, 2014, 2012, 2011 and 2010, respectively. There were no loans held for sale at December 31, 2013.

(3) Balances are net of undisbursed loan proceeds.

(4) Percent of total noncovered loans.

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The following table provides information about our covered loan portfolio by type of loan at the dates indicated. These balances are the recorded investment balance and are prior to deduction for the allowance for loan losses.

	December 31,									
	2014		2013		2012		2011		2010	
	Balance	% of Total (3)	Balance	% of Total (3)	Balance	% of Total (3)	Balance	% of Total (3)	Balance	% of Total (3)
	(Dollars in thousands)									
Covered loans:										
Commercial business:										
Commercial and industrial(1)	$78,354	62.1 %	$39,056	61.3 %	$60,577	68.6 %	$76,674	70.1 %	92,265	71.7 %
Non-owner occupied commercial real estate	26,879	21.3	14,625	22.9	13,028	14.7	15,753	14.4	17,576	13.6
Total commercial business	105,233	83.4	53,681	84.2	73,605	83.3	92,427	84.5	109,841	85.3
One-to-four family residential	5,990	4.7	4,777	7.5	5,027	5.7	5,197	4.8	6,224	4.8
Real estate construction and land development:										
One-to-four family residential	2,446	2.0	1,556	2.4	4,433	5.0	5,786	5.3	5,876	4.6
Five or more family residential and commercial properties	3,560	2.8	—	—	—	—	—	—	—	—
Total real estate construction and land development(2)	6,006	4.8	1,556	2.4	4,433	5.0	5,786	5.3	5,876	4.6
Consumer	8,971	7.1	3,740	5.9	5,265	6.0	5,947	5.4	6,774	5.3
Gross purchased covered loans	$126,200	100.0 %	$63,754	100.0 %	$88,330	100.0%	$109,357	100.0%	128,715	100.0 %

(1)Commercial and industrial loans include owner-occupied commercial real estate.
(2)Balances are net of undisbursed loan proceeds.
(3)Percent of total covered loans.

The following table presents at December 31, 2014 (i) the aggregate contractual maturities of noncovered loans in the named categories of our noncovered loan portfolio and (ii) the aggregate amounts of fixed rate and variable or adjustable rate loans in the named categories that mature after one year.

	Maturing Within 1 year	Over 1-5 years	After 5 years	Total
	(In thousands)			

Commercial business	$230,085	$407,886	$1,065,871	$1,703,842
Real estate construction and land development	42,411	34,692	31,006	108,109
Total	$272,496	$442,578	$1,096,877	$1,811,951
Fixed rate loans, due after 1 year		$236,357	$217,816	$454,173
Variable or adjustable rate loans, due after 1 year		206,221	879,061	1,085,282
Total		$442,578	$1,096,877	$1,539,455

Commercial Business Lending

We offer different types of commercial business loans, including lines of credit, term equipment financing and term owner-occupied commercial real estate loans. We also originate loans that are guaranteed by the Small Business Administration (“SBA”), for which Heritage Bank is a “preferred lender.” Before extending credit to a business we review and analyze the borrower’s management ability, financial history, including cash flow of the borrower and all guarantors, and the liquidation value of the collateral. Emphasis is placed on having a comprehensive understanding of the borrower’s global cash flow and performing necessary financial due diligence.

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At December 31, 2014 we had $1.70 billion, or 80.2%, of our total noncovered loans receivable in commercial business loans with an average loan size of approximately $306,000, excluding loans with no outstanding balance. We originate commercial real estate loans within our primary market areas with a preference for loans secured by owner-occupied properties. Our underwriting standards require that commercial real estate loans not exceed 75% of the lower of appraised value at origination or cost of the underlying collateral. Cash flow coverage to debt servicing requirements is generally a minimum of 1.15 times for five or more family residential loans and 1.25 times for commercial real estate loans. Cash flow coverage is calculated using an “underwriting” interest rate that is higher than the note rate.

Commercial real estate loans typically involve a greater degree of risk than one-to-four family residential loans. Payments on loans secured by commercial real estate properties are dependent on successful operation and management of the properties and repayment of these loans may be affected by adverse conditions in the real estate market or the economy. We seek to minimize these risks by determining the financial condition of the borrower, the quality and value of the collateral, and the management of the property securing the loan. We also generally obtain personal guarantees from the owners of the collateral after a thorough review of personal financial statements. In addition, we review our commercial real estate loan portfolio annually for performance of individual loans, and stress-test loans for potential changes in interest rates, occupancy, and collateral values.

See “Item 1A. Risk Factors—Our loan portfolio is concentrated in loans with a higher risk of loss—Repayment of our commercial business loans, consisting of commercial and industrial loans as well as owner-occupied and non-owner occupied commercial real estate loans, is often dependent on the cash flows of the borrower, which may be unpredictable, and the collateral securing these loans may fluctuate in value.” See also “Item 1A. Risk Factors—Our loan portfolio is concentrated in loans with a higher risk of loss—Our non-owner occupied commercial real estate loans, which includes five or more family residential real estate loans, involve higher principal amounts than other loans and repayment of these loans may be dependent on factors outside our control or the control of our borrowers.”

One-to-Four Family Residential Loans, Originations and Sales

The majority of our one-to-four family residential loans are secured by single-family residences located in our primary market areas. Our underwriting standards require that one-to-four family residential loans generally are owner-occupied and do not exceed 80% of the lower of appraised value at origination or cost of the underlying collateral. Terms typically range from 15 to 30 years.

As part of our asset/liability management strategy, we typically sell a significant portion of our one-to-four family residential loans in the secondary market. See “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations—Asset/Liability Management.” We discontinued this strategy in the second quarter of 2013 through the second quarter of 2014, and reinstated these operations following the completion of the Washington Banking Merger.

We typically sell the servicing of the sold one-to-four family residential loans, or the collection of principal and interest payments, to other financial institutions. We did not service any of these sold loans for others for the years ended December 31, 2014 or 2013.

The following table presents summary information concerning our origination and sale of our one-to-four family residential loans and the gains from the sale of loans.

	Years Ended December 31,				
	2014	2013	2012	2011	2010
	(In thousands)				
One-to-four family residential loans:					
Originated (1)	$75,500	$18,867	$35,730	$23,865	$18,605
Sold	55,997	8,460	21,187	15,888	16,187
Gains on sales of loans, net (2)	1,080	142	295	285	226

(1) Includes loans originated for our loan portfolio or for sale in the secondary market.
(2) Excludes net gains on sales of SBA loans.

Real Estate Construction and Land Development

We originate one-to-four family residential construction loans for the construction of custom homes (where the home buyer is the borrower). We also provide financing to builders for the construction of pre-sold homes and, in selected cases, to builders for the construction of speculative residential property. Because of the higher risks present in the residential construction industry, our lending to builders is limited to those who have demonstrated a favorable record of performance and who are building in markets that management understands.

We further endeavor to limit our construction lending risk through adherence to strict underwriting guidelines and procedures. Speculative construction loans are short term in nature and have a variable rate of interest. We require builders to have tangible equity in each construction project and have prompt and thorough documentation of all draw requests, and we inspect the project prior to paying any draw requests.

See “Item 1A. Risk Factors—Our loan portfolio is concentrated in loans with a higher risk of loss—Our real estate construction and land development loans are based upon estimates of costs and value associated with the completed project. These estimates may be inaccurate.”

Consumer

We originate consumer loans and lines of credit that are both secured and unsecured. The majority of our consumer loans are for relatively small amounts disbursed among many individual borrowers.

As a result of the Washington Banking Merger, we originate indirect consumer loans. These loans are for new and used automobile and recreational vehicles that are originated indirectly by selected dealers located in our market areas. We have limited our indirect loans purchased primarily to dealerships that are established and well known in their market areas and to applicants that are not classified as sub-prime.

Commitments and Contingent Liabilities

In the ordinary course of business, we enter into various types of transactions that include commitments to extend credit that are not included in our Consolidated Financial Statements. We apply the same credit standards to these commitments as we use in all our lending activities and have included these commitments in our lending risk evaluations. Our exposure to credit loss under commitments to extend credit is represented by the amount of these commitments.

The following table presents outstanding commitments to extend credit, including letters of credit, at the dates indicated:

	December 31, 2014	December 31, 2013
	(In thousands)	
Commercial business:		
Commercial and industrial	$288,930	$169,079
Owner-occupied commercial real estate	2,648	2,812
Non-owner occupied commercial real estate	20,240	2,405
Total commercial business	311,818	174,296
One-to-four family residential	—	45
Real estate construction and land development:		
One-to-four family residential	24,028	12,236
Five or more family residential and commercial properties	32,653	20,720
Total real estate construction and land development	56,681	32,956
Consumer	122,633	27,480
Total outstanding commitments	$491,132	$234,777

Delinquencies and Nonperforming Assets

Delinquency Procedures. Delinquencies in the commercial business loan portfolio are handled by the assigned loan officer. Loan officers are responsible for collecting loans they originate or which are assigned to them. We send a borrower a delinquency notice 15 days after the due date when the borrower fails to make a required payment on a loan. If the delinquency is not brought current, additional delinquency notices are mailed at 30 and 45 days for commercial loans. Additional written and oral contacts are made with the borrower between 60 and 90 days after the

due date.

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If a real estate loan payment is past due for 45 days or more, the collection manager may perform a review of the condition of the property. Depending on the nature of the loan and the type of collateral securing the loan, we may negotiate and accept a modified payment program with the borrower, accept a voluntary deed in lieu of foreclosure or, when considered necessary, begin foreclosure proceedings. If foreclosed on, real property is generally sold at a public sale and we may bid on the property to protect our interest. A decision as to whether and when to begin foreclosure proceedings is based on such factors as the amount of the outstanding loan relative to the value of the property securing the original indebtedness, the extent of the delinquency, and the borrower's ability and willingness to cooperate in resolving the delinquency.

Real estate acquired by us in partial or full satisfaction of a loan obligation is classified as other real estate owned until it is sold. When property is acquired, it is recorded at the estimated fair value (less costs to sell) at the date of acquisition, not to exceed net realizable value, and any resulting write-down is charged to the allowance for loan losses. Upon acquisition, all costs incurred in maintaining the property are expensed. Costs relating to the development and improvement of the property, however, are capitalized to the extent of the property's net realizable value. If the estimated realizable value of the other real estate owned property declines after the acquisition date, the adjustment to the value is charged to other real estate owned expense, net.

Classification of Loans.   Federal regulations require that the Bank periodically evaluate the risks inherent in its loan portfolio. In addition, the Division of Banks of the Washington State Department of Financial Institutions ("Division") and the FDIC have the authority to identify problem loans and, if appropriate, require them to be reclassified. There are three classifications for problem loans: Substandard, Doubtful, and Loss. Substandard loans have one or more defined weaknesses and are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected. Doubtful loans have the weaknesses of Substandard loans, with additional characteristics that the weaknesses make collection or liquidation in full on the basis of currently existing facts, conditions, and values questionable. There is a high probability of some loss in loans classified as Doubtful. A loan classified as Loss is considered uncollectible and of such little value that continuance as a loan of the institution is not warranted. If a loan or a portion of the loan is classified as Loss, the institution must charge-off this amount. We also have loans we classify as Watch and Other Assets Especially Mentioned ("OAEM"). Loans classified as Watch are performing assets but have elements of risk that require more monitoring than other performing loans. Loans classified as OAEM are assets that continue to perform but have shown deterioration in credit quality and require closer monitoring.

The Bank routinely tests its problem loans for potential impairment. A loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect all amounts due according to the original contractual terms of the loan agreement. Problem loans that may be impaired are identified using the Bank's normal loan review procedures, which include post-approval reviews, monthly reviews by credit administration of criticized loan reports, scheduled internal reviews, underwriting during extensions and renewals and the analysis of information routinely received on a borrower's financial performance.

Impairment is measured using the present value of expected future cash flows, discounted at the loan's effective interest rate, unless the loan is collateral dependent, in which case impairment is measured using the fair value of the collateral after deducting appropriate collateral disposition costs. Furthermore, when it is practically expedient, impairment is measured by the fair market price of the loan.

Subsequent to an initial measure of impairment, if there is a significant change in the amount or timing of a loan's expected future cash flows or a change in the value of collateral or market price of a loan, based on new information received, the impairment is recalculated. However, the net carrying value of a loan never exceeds the recorded investment in the loan.

Nonperforming Assets.   Nonperforming assets consist of nonaccrual loans and other real estate owned. The following table provides information about our noncovered nonaccrual loans and other real estate owned for the indicated dates. We have also included information regarding our troubled-debt restructured performing noncovered loans for the indicated dates, although these are not considered nonperforming assets as they continue to accrue interest despite being considered impaired due to the restructure.

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	December 31,				
	2014	2013	2012	2011	2010
	(Dollars in thousands)				
Nonaccrual noncovered loans:					
Commercial business	$4,719	$5,675	$6,068	$8,266	$10,839
One-to-four family residential	—	340	450	—	2
Real estate construction and land development	2,652	1,045	6,420	14,947	15,642
Consumer	139	678	281	615	—
Total nonaccrual noncovered loans(1)(2)	7,510	7,738	13,219	23,828	26,483
Noncovered other real estate owned	2,178	4,377	5,406	3,710	3,030
Total nonperforming noncovered assets	$9,688	$12,115	$18,625	$27,538	$29,513
Accruing noncovered loans past due 90 days or more(3)	$—	$6	$214	$1,328	$1,313
Potential problem noncovered loans(4)	117,250	52,814	29,183	31,925	53,086
Allowance for loan losses on noncovered loans	22,153	22,657	24,242	26,952	22,062
Nonperforming noncovered loans to total noncovered loans	0.35 %	0.66 %	1.41 %	2.57 %	3.03 %
Allowance for loan losses on noncovered loans to total noncovered loans	1.04 %	1.94 %	2.58 %	2.91 %	2.53 %
Allowance for loan losses on noncovered loans to nonperforming noncovered loans	294.98 %	292.80 %	183.39 %	113.11 %	83.31 %
Nonperforming noncovered assets to total noncovered assets	0.29 %	0.76 %	1.48 %	2.19 %	2.38 %
Restructured performing noncovered loans:					
Commercial business	$14,408	$15,735	$15,227	$12,606	$394
One-to-four family residential	245	252	888	835	—
Real estate construction and land development	3,927	6,043	361	364	—
Consumer	184	101	—	—	—
Total restructured performing noncovered loans(5)	$18,764	$22,131	$16,476	$13,805	$394

(1) At December 31, 2014, 2013, 2012, 2011 and 2010, $4.1 million, $2.6 million, $9.3 million, $11.7 million and $8.7 million of nonaccrual noncovered loans were considered troubled debt restructured loans, respectively.

(2) At December 31, 2014, 2013, 2012, 2011 and 2010, $1.6 million, $1.7 million, $1.2 million, $1.8 million and $2.3 million of noncovered nonaccrual loans were guaranteed by government agencies, respectively.

(3) There were no accruing noncovered loans past due 90 days or more that were guaranteed by government agencies at December 31, 2014, 2013, and 2012. There were accruing noncovered loans past due 90 days or more of $6,000 and $92,000 guaranteed by government agencies at December 31, 2011 and 2010, respectively.

(4) At December 31, 2014, 2013, 2012, 2011 and 2010, $2.0 million, $1.8 million, $2.9 million, $2.8 million and $5.4 million of potential problem noncovered loans were guaranteed by government agencies, respectively.

(5) At December 31, 2014, 2013, 2012 and 2011, $751,000, $1.2 million, $965,000 and $592,000 of restructured performing noncovered loans were guaranteed by government agencies . There were no restructured performing noncovered loans guaranteed by government agencies at December 31, 2010.

Nonaccrual Loans. Our Consolidated Financial Statements are prepared on the accrual basis of accounting, including the recognition of interest income on our loan portfolio, unless a loan is placed on nonaccrual status. Loans are considered to be impaired and are placed on nonaccrual status when there are serious doubts about the collectability of principal or interest. Our policy is to place a loan on nonaccrual status when the loan becomes past due for 90 days or more, is less than fully collateralized, and is not in the process of collection. Payments received on nonaccrual loans generally are applied first to principal and then to interest only after all principal has been collected.

Nonaccrual noncovered loans decreased to $7.5 million, or 0.35% of total noncovered loans, at December 31, 2014 from $7.7 million, or 0.66% of total noncovered loans, at December 31, 2013 due to the loan resolution efforts of our credit department. During the year ended December 31, 2014, approximately $9.6 million in net principal payments were received on nonaccrual noncovered loans and $322,000 of nonaccrual noncovered loans were transferred back to accrual status. We also recorded $1.6 million in net charge-offs of nonaccrual noncovered loans. In addition, $414,000 of nonaccrual noncovered loans were transferred to other real estate owned during the year ended December 31, 2014. The decrease in total nonaccrual noncovered loans at December 31, 2014 was partially offset by $11.7 million in additions to nonperforming noncovered loans, of which $1.4 million were previously restructured performing noncovered loans that were transferred to nonaccrual status.

Nonperforming noncovered assets decreased to $9.7 million, or 0.29% of total noncovered assets, at December 31, 2014 from $12.1 million, or 0.76% of total noncovered assets, at December 31, 2013 due to a decrease in nonperforming noncovered loans discussed above as well as an overall decrease in noncovered other real estate owned. The noncovered other real estate owned decreased to $2.2 million at December 31, 2014 from $4.4 million at December 31, 2013 due to dispositions of $5.6 million, which were offset partially by additions of $3.3 million during the year ended December 31, 2014. Of the $3.3 million of additions, $1.7 million were acquired with the Washington Banking Merger.

Restructured performing noncovered loans as of December 31, 2014 and December 31, 2013 were $18.8 million and $22.1 million, respectively. The $3.4 million decrease in restructured performing noncovered loans during 2014 was primarily due to $7.3 million of net principal reductions and $1.5 million in loans transferred to nonaccrual, offset partially by $3.8 million of loans restructured during the year ended December 31, 2014 and $2.5 million of advances of existing restructured performing noncovered loans. The Bank also recorded $372,000 in charge-offs of restructured performing noncovered loans during the year ended December 31, 2014.

Troubled Debt Restructured Loans. A troubled debt restructured loan (“TDR”) is a restructuring in which the Bank, for economic or legal reasons related to a borrower’s financial difficulties, grants a concession to a borrower that it would not otherwise consider. The majority of the Bank's TDRs are a result of granting extensions to troubled credits which have already been adversely classified. We grant such extensions to reassess the borrower’s financial status and develop a plan for repayment. Certain modifications with extensions also include interest rate reductions, which is the second most prevalent concession. The interest rate reductions can be for a period of time or over the remainder of the life of the loan. We may also bifurcate troubled credits into a “good” loan and a “bad” loan, whereas the good loan continues to accrue under the modified terms. We perform bifurcations to limit potential losses. The remainder of the Bank's TDRs are the result of converting revolving lines of credits to amortizing loans, changing amortizing loans to interest-only loans with balloon payments, or re-amortizing the loan over a longer period of time. These modifications would all be considered a concession for a borrower that could not obtain financing outside of the Bank. We do not forgive principal for a majority of our TDRs, but in those situations where principal is forgiven, the entire amount of such principal forgiveness is immediately charged off to the extent not done so prior to the modification. We sometimes delay the timing on the repayment of a portion of principal (principal forbearance) and charge-off the amount of forbearance if that amount is not considered fully collectible. We also consider insignificant delays in payments when determining if a loan should be classified as a TDR.

TDRs are considered impaired and are separately measured for impairment under Financial Accounting Standards Board ("FASB") Accounting Standards Codification (“ASC”) 310-10-35, whether on accrual or nonaccrual status. At December 31, 2014 and December 31, 2013, the balance of performing noncovered TDRs was $18.8 million and $22.1 million, respectively. The related allowance for loan losses on the performing noncovered TDRs was $1.9 million as of December 31, 2014 and $3.0 million as of December 31, 2013. At December 31, 2014, nonperforming noncovered TDRs were $5.0 million and had a related allowance for loan losses of $1.0 million. At December 31, 2013, nonperforming noncovered TDRs of $2.6 million had a related allowance for loan losses of $191,000.

A loan may have the TDR classification removed if (a) the restructured interest rate was greater than or equal to the interest rate of a new loan with comparable risk at the time of the restructure, and (b) the loan is no longer impaired based on the terms of the restructured agreement. The Bank's policy is that the borrower must demonstrate six

consecutive monthly payments in accordance with the modified loan terms before it can be reviewed for removal of TDR classification under the second criteria. However, the loan must be reported as a TDR in at least one of the Company's Annual Reports on Form 10-K. Once a loan has been classified as a TDR, it will continue to be an impaired loan until paid off or charged-off, even if the loan subsequently is no longer a TDR.

Potential Problem Loans. Potential problem loans are those loans that are currently accruing interest and are not considered impaired, but which we are monitoring because the financial information of the borrower causes us concerns as to their ability to comply with their loan repayment terms. Loans that are past due 90 days or more and still accruing interest are both well-secured and in the process of collection. Potential problem noncovered loans

increased $64.4 million, or 122.0%, to $117.3 million at December 31, 2014 from $52.8 million at December 31, 2013 primarily due to loans acquired in the Washington Banking Merger.

Analysis of Allowance for Loan Losses

Management maintains an allowance for loan losses ("ALL") to provide for estimated probable credit losses inherent in the loan portfolio. The adequacy of the ALL is monitored through our ongoing quarterly loan quality assessments.

We assess the estimated credit losses inherent in our loan portfolio by considering a number of elements including:

- Historical loss experience in a number of homogeneous segments of the loan portfolio;
- The impact of environmental factors, including:
  - Levels of and trends in delinquencies and impaired loans;
  - Levels and trends in charge-offs and recoveries;
  - Effects of changes in risk selection and underwriting standards, and other changes in lending policies, procedures and practices;
  - Experience, ability, and depth of lending management and other relevant staff;
  - National and local economic trends and conditions;
  - External factors such as competition, legal, and regulatory requirements; and
  - Effects of changes in credit concentrations.

We calculate an appropriate ALL for the loans in our loan portfolio by applying historical loss factors for homogeneous classes of the portfolio, adjusted for changes to the above-noted environmental factors. We may record specific provisions for impaired loans, including loans on nonaccrual status and TDRs, after a careful analysis of each loan's credit and collateral factors. Our analysis of an appropriate ALL combines the provisions made for our non-impaired loans and the specific provisions made for each impaired loan.

While we believe we use the best information available to determine the allowance for loan losses, results of operations could be significantly affected if circumstances differ substantially from the assumptions used in determining the allowance. A decline in local and national economic conditions, or other factors, could result in a material increase in the allowance for loan losses and may adversely affect the Company's financial condition and results of operations. In addition, the determination of the amount of the allowance for loan losses is subject to review by bank regulators, as part of their routine examination process, which may result in the establishment of additional allowance allocations based upon their judgment of information available to them at the time of their examination.

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The following table provides information regarding changes in our allowance for loan losses on noncovered loans at and for the indicated periods:

	At or For the Years Ended December 31,				
	2014	2013	2012	2011	2010
	(Dollars in thousands)				
Allowance for loan losses on noncovered loans at beginning of the year	$22,657	$24,242	$26,952	$22,062	$26,164
Provision for loan losses for noncovered loans	2,232	1,784	1,570	10,032	11,990
Charge-offs:					
Commercial business	(2,305)	(3,295)	(3,726)	(2,972)	(8,106)
One-to-four family residential	—	(52)	(391)	(53)	(169)
Real estate construction and land development	(376)	(565)	(1,280)	(2,513)	(8,344)
Consumer	(962)	(386)	(620)	(648)	(73)
Total charge-offs on noncovered loans	(3,643)	(4,298)	(6,017)	(6,186)	(16,692)
Recoveries:					
Commercial business	716	807	1,579	821	243
One-to-four family residential	—	—	—	—	15
Real estate construction and land development	50	32	125	201	285
Consumer	141	90	33	22	57
Total recoveries on noncovered loans	907	929	1,737	1,044	600
Net charge-offs on noncovered loans	(2,736)	(3,369)	(4,280)	(5,142)	(16,092)
Allowance for loan losses on noncovered loans at end of the year	$22,153	$22,657	$24,242	$26,952	$22,062
Noncovered loans outstanding at end of the year(1)(2)	$2,125,814	$1,170,836	$940,704	$927,898	$874,391
Average noncovered loans receivable during the year(2)	1,767,821	1,052,552	897,342	862,812	745,819
Ratio of net charge-offs on noncovered loans to average noncovered loans receivable	(0.15)%	(0.32)%	(0.48)%	(0.60)%	(2.16)%

(1) Gross loan balances.
(2) Excludes loans held for sale.

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The following table shows the allocation of the allowance for loan losses on noncovered loans at the indicated dates. The allocation is based upon an evaluation of defined loan problems, historical loan loss ratios, and industry wide and other factors that affect loan losses in the categories shown below:

	December 31,														
	2014			2013			2012			2011			2010		
	Allowance for Loan Losses	% of Total (1)		Allowance for Loan Losses	% of Total (1)		Allowance for Loan Losses	% of Total (1)		Allowance for Loan Losses	% of Total (1)		Allowance for Loan Losses	% of Total (1)	
	(Dollars in thousands)														
Commercial business	$15,967	80.1	%	$18,020	86.9	%	$16,044	83.0	%	$16,167	81.6	%	$14,350	82.5	%
One-to-four family residential	812	3.0		786	3.7		944	4.4		650	4.4		500	6.5	
Real estate construction	1,954	5.1		1,884	5.8		4,801	8.4		7,978	8.6		5,435	7.8	
Consumer	2,604	11.8		1,366	3.6		1,583	4.2		1,247	5.4		846	3.2	
Unallocated	816	—		601	—		870	—		910	—		931	—	
Total allowance for loan losses on noncovered loans (1)	$22,153	100.0	%	$22,657	100.0	%	$24,242	100.0	%	$26,952	100.0	%	$22,062	100.0	%

(1) Represents total noncovered loans outstanding in each category as a percent of gross noncovered loans.

The following table shows the allocation of the allowance for loan losses on covered loans at the indicated dates. The allocation is based upon an evaluation of defined loan problems, historical loan loss ratios, and industry wide and other factors that affect loan losses in the categories shown below:

	December 31,														
	2014			2013			2012			2011			2010 (2)		
	Allowance for Loan Losses	% of Total (1)		Allowance for Loan Losses	% of Total (1)		Allowance for Loan Losses	% of Total (1)		Allowance for Loan Losses	% of Total (1)		Allowance for Loan Losses	% of Total (1)	
	(Dollars in thousands)														
Commercial business	$4,219	83.4	%	$4,833	84.2	%	$3,258	83.3	%	$3,011	84.5	%	$—	85.3	%
One-to-four family residential	388	4.7		314	7.5		277	5.7		144	4.8		—	4.8	
Real estate construction	804	4.8		789	2.4		639	5.0		645	5.3		—	4.6	
Consumer	165	7.1		231	5.9		178	6.0		163	5.4		—	5.3	
Unallocated	—	—		—	—		—	—		—	—		—	—	
Total allowance for loan losses on	$5,576	100.0	%	$6,167	100.0	%	$4,352	100.0	%	$3,963	100.0	%	$—	100.0	%

covered
loans (1)

(1) Represents total covered loans outstanding in each category as a percent of gross covered loans.

(2) The Company did not have an allowance for loan losses on covered loans at December 31, 2010 as the covered portfolio was acquired in July 2010 and fair value discounts on covered loans established at acquisition date were determined sufficient to absorb known and inherent loan losses at December 31, 2010.

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Investment Activities

At December 31, 2014, our investment securities portfolio totaled $778.7 million, which consisted of $742.8 million of securities available for sale and $35.8 million of securities held to maturity. This compares with a total portfolio of $199.3 million at December 31, 2013, which was comprised of $163.1 million of securities available for sale and $36.2 million of securities held to maturity. The increase in our investment securities portfolio in fiscal 2014 is attributable to investment securities acquired in the Washington Banking Merger. The composition of the investment portfolio by type of security, at each respective date, is presented in Note 4 - Investment Securities of the Notes to Consolidated Financial Statements included in "Item 8. Financial Statements and Supplementary Data."

Our investment policy is established by the Board of Directors and monitored by the Audit and Finance Committee of the Board of Directors. It is designed primarily to provide and maintain liquidity, generate a favorable return on investments without incurring undue interest rate and credit risk, and complements the Bank's lending activities. The policy dictates the criteria for classifying securities as either available for sale or held to maturity. The policy permits investment in various types of liquid assets permissible under applicable regulations, which include U.S. Treasury obligations, U.S. Government agency obligations, some certificates of deposit of insured banks, mortgage backed and mortgage related securities, corporate notes, municipal bonds, and federal funds. Investment in non-investment grade bonds and stripped mortgage backed securities are not permitted under the policy.

The following table provides information regarding our investment securities available for sale at the dates indicated.

	December 31, 2014			December 31, 2013			December 31, 2012		
	Fair Value	% of Total Investments		Fair Value	% of Total Investments		Fair Value	% of Total Investments	
	(Dollars in thousands)								
U.S. Treasury and U.S. Government-sponsored agencies	$21,427	2.9	%	$6,039	3.7	%	$11,035	7.7	%
Municipal securities	173,037	23.3		49,060	30.1		47,360	32.8	
Mortgage backed securities and collateralized mortgage obligations-residential:									
U.S. Government-sponsored agencies	542,399	73.0		108,035	66.2		85,898	59.5	
Corporate obligations	4,010	0.5		—	—		—	—	
Mutual funds and other equities	1,973	0.3		—	—		—	—	
Total	$742,846	100.0	%	$163,134	100.0	%	$144,293	100.0	%

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The following table provides information regarding our investment securities available for sale, by contractual maturity, at December 31, 2014.

	Less Than One Year			Over One to Five Years			Over Five to Ten Years			Over Ten Years		
	Fair Value	Weighted Average Yield(1)		Fair Value	Weighted Average Yield(1)		Fair Value	Weighted Average Yield(1)		Fair Value	Weighted Average Yield(1)	
	(Dollars in thousands)											
U.S. Treasury and U.S. Government-sponsored agencies	$—	—	%	$20,836	1.04	%	$591	1.95	%	$—	—	%
Municipal securities	4,171	1.93		26,360	2.50		65,805	3.26		76,701	3.76	
Mortgage backed securities and collateralized mortgage obligations-residential:												
U.S. Government-sponsored agencies	—	—		8,601	2.40		81,540	1.81		452,258	2.09	
Corporate obligations	—	—		—	—		4,010	1.15		—	—	
Total	$4,171	1.93	%	$55,797	1.91	%	$151,946	2.42	%	$528,959	2.32	%

(1)Taxable equivalent weighted average yield.

The following table provides information regarding our investment securities held to maturity at the dates indicated.

	December 31, 2014			December 31, 2013			December 31, 2012		
	Amortized Cost	% of Total Investments		Amortized Cost	% of Total Investments		Amortized Cost	% of Total Investments	
	(Dollars in thousands)								
U.S. Treasury and U.S. Government-sponsored agencies	$1,591	4.4	%	$1,687	4.7	%	$1,740	17.2	%
Municipal securities	22,486	62.8		24,290	67.2		2,946	29.2	
Mortgage backed securities and collateralized mortgage obligations-residential:									
U.S. Government-sponsored agencies	10,866	30.4		9,129	25.2		4,245	42.0	
Private residential collateralized mortgage obligations	871	2.4		1,048	2.9		1,168	11.6	
Total	$35,814	100.0	%	$36,154	100.0	%	$10,099	100.0	%

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The following table provides information regarding our investment securities held to maturity, by contractual maturity, at December 31, 2014.

	Less Than One Year			Over One to Five Years			Over Five to Ten Years			Over Ten Years		
	Amortized Cost	Weighted Average Yield(1)		Amortized Cost	Weighted Average Yield(1)		Amortized Cost	Weighted Average Yield(1)		Amortized Cost	Weighted Average Yield(1)	
	(Dollars in thousands)											
U.S. Treasury and U.S. Government-sponsored agencies	$—	—	%	$492	3.76	%	$1,099	3.91	%	$—	—	%
Municipal securities	2,895	2.53		8,826	3.05		10,557	3.88		208	5.61	
Mortgage backed securities and collateralized mortgage obligations-residential:												
U.S. Government-sponsored agencies	—	—		508	2.56		6,902	3.25		3,456	2.88	
Private residential collateralized mortgage obligations	—	—		—	—		—	—		871	5.95	
Total	$2,895	2.53	%	$9,826	3.06	%	$18,558	3.64	%	$4,535	3.59	%

(1)Taxable equivalent weighted average yield.

The Bank is required to maintain an investment in the stock of the Federal Home Loan Bank ("FHLB") of Seattle in an amount equal to the greater of $500,000 or 0.50% of residential mortgage loans and pass-through securities or an advance requirement to be confirmed on the date of the advance and 5.0% of the outstanding balance of mortgage loans sold to the FHLB of Seattle. At December 31, 2014 the Bank was required to maintain an investment in the stock of FHLB of Seattle of at least $3.3 million and had an investment in FHLB stock carried at a cost basis (par value) of $12.2 million.

Consistent with its accounting policy, the Company evaluated its investment in FHLB of Seattle stock for other-than-temporary impairment. The Company took into consideration that in September 2012, the FHLB of Seattle announced that it had been reclassified as adequately capitalized by its regulator, the Federal Housing Finance Agency("FHFA"). Further, during the year ended December 31, 2012, the FHFA granted the FHLB of Seattle authority to repurchase up to $25 million of excess capital stock per quarter at par ($100 per share), provided they receive a non-objection for each quarter's repurchase from the FHFA. The FHLB of Seattle had been repurchasing stock throughout 2013 and 2014. On December 22, 2014 the FHLB of Seattle and the FHLB of Des Moines announced that the FHFA had approved their merger application submitted on October 31, 2014, subject to satisfaction of specific closing conditions set forth in the FHFA approval letter, including the receipt of approvals by members of both FHLBs. The voting process for both FHLBs is anticipated to conclude in late February 2015. The boards of directors of both FHLBs have unanimously approved the proposed merger. The combined FHLB would be headquartered in Des Moines and maintain a regional office in Seattle. The members of the combined organization would have access to an enhanced suite of products and services and benefit from increased economies of scale and greater risk diversification.

Based on the Company's evaluation of the underlying investment, including the long-term nature of the investment, the liquidity position of the FHLB of Seattle, the proposed FHLB merger and the Company's intent and ability to hold the investment for a period of time sufficient to recover the par value, the Company did not recognize an

other-than-temporary impairment loss on its FHLB of Seattle stock during the years ended December 31, 2014,

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2013 and 2012. Despite improvements in the FHLB of Seattle's financial condition, any deterioration in the FHLB of Seattle's financial position may result in future impairment losses.

Deposit Activities and Other Sources of Funds

General. Our primary sources of funds are deposits, loan repayments and borrowings. Scheduled loan repayments are a relatively stable source of funds, while deposits and unscheduled loan prepayments, which are influenced significantly by general interest rate levels, interest rates available on other investments, competition, economic conditions, and other factors are not. Customer deposits remain an important source of funding, but these balances have been influenced in the past by adverse market conditions in the industry and may be affected by future developments such as interest rate fluctuations and new competitive pressures. In addition to customer deposits, management may utilize brokered deposits on an as-needed basis.

Borrowings may also be used on a short-term basis to compensate for reductions in other sources of funds (such as deposit inflows at less than projected levels). Borrowings may also be used on a longer-term basis to support expanded lending activities and match the maturity of repricing intervals of assets. In addition, the Company utilizes repurchase agreements as a supplement to other funding sources.

During the year ended December 31, 2014, non-maturity deposits (total deposits less certificate of deposit accounts) increased by $1.29 billion, or 118.5%, to $2.38 billion from $1.09 billion at December 31, 2013. The increase was primarily a result of the non-maturity deposits acquired in the Washington Banking Merger. The percentage of non-maturity deposits to total deposits increased to 81.9% at December 31, 2014 compared to 77.9% at December 31, 2013. As a result of this increase, the certificate of deposit accounts to total deposits decreased to 18.1% at December 31, 2014 from 22.1% at December 31, 2013.

Deposit Activities. We offer a variety of deposit accounts designed to attract both short-term and long-term deposits. These accounts include noninterest demand accounts, negotiable order of withdrawal ("NOW") accounts, money market accounts, savings accounts and certificates of deposit ("CDs"). These accounts, with the exception of noninterest demand accounts, generally earn interest at rates established by management based on competitive market factors and management's desire to increase or decrease certain types or maturities of deposits. The major categories of deposit accounts are described below.

Noninterest Demand Deposits. Noninterest demand deposits are noninterest bearing and may be charged service fees based on activity and balances.

NOW Accounts. NOW accounts are interest bearing and may be charged service fees based on activity and balances. NOW accounts pay interest, but require a higher minimum balance to avoid service charges.

Money Market Accounts. Money market accounts pay a variable interest rate that is tiered depending on the balance maintained in the account. Minimum opening balances vary.

Savings Accounts. We offer savings accounts that allow for unlimited deposits and withdrawals, provided that a $300 minimum balance is maintained.

CDs. We offer several types of CDs with maturities ranging from three months to five years, which require a minimum deposit of $2,500. Negotiable CDs are offered in amounts of $100,000 or more for terms of 30 days to five years.

The following table provides the balances outstanding for each major category of deposits at the dates indicated:

	December 31, 2014			December 31, 2013			December 31, 2012		
	Amount	Percent		Amount	Percent		Amount	Percent	
	(Dollars in thousands)								
Noninterest demand deposits	$709,673	24.4	%	$349,902	25.0	%	$247,048	22.1	%
NOW accounts	793,362	27.3		352,051	25.2		303,487	27.2	
Money market accounts	520,065	17.9		232,016	16.6		157,728	14.1	
Savings accounts	357,834	12.3		155,790	11.1		120,781	10.8	
Total non-maturity deposits	2,380,934	81.9		1,089,759	77.9		829,044	74.2	
CDs	525,397	18.1		309,430	22.1		288,927	25.8	

Total deposits	$2,906,331	100.0	%	$1,399,189	100.0	%	$1,117,971	100.0	%

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The following table provides the average balances outstanding and the weighted average interest rates for each major category of deposits for the years indicated:

	Years Ended December 31,					
	2014		2013		2012	
	Average Balance	Average Yield/Rate	Average Balance	Average Yield/Rate	Average Balance	Average Yield/Rate
	(Dollars in thousands)					
NOW accounts and money market accounts	$1,049,078	0.18 %	$541,793	0.19 %	$466,268	0.27 %
Savings accounts	282,150	0.09	143,412	0.11	113,119	0.18
CDs	494,948	0.60	307,464	0.81	306,772	0.98
Total interest bearing deposits	1,826,176	0.28	992,669	0.37	886,159	0.50
Noninterest demand deposits	574,692	—	308,582	—	237,888	—
Total deposits	$2,400,868	0.21 %	$1,301,251	0.28 %	$1,124,047	0.40 %

The following table shows the amount and maturity of certificates of deposit of $100,000 or more:

	December 31, 2014
	(In thousands)
Remaining maturity:	
Three months or less	$1,441
Over three months through twelve months	167,863
Over twelve months through three years	79,922
Over three years	17,356
Total	$266,582

Borrowings. Deposits are the primary source of funds for our lending and investment activities and our general business purposes. We rely upon advances from the FHLB to supplement our supply of lendable funds and meet deposit withdrawal requirements. The FHLB of Seattle serves as one of our secondary sources of liquidity. Advances from the FHLB of Seattle are typically secured by our first lien one-to-four family residential loans, commercial real estate loans and stock issued by the FHLB, which is owned by us. At December 31, 2014, the Bank maintained an uncommitted credit facility with the FHLB of Seattle of $374.3 million and an uncommitted credit facility with the Federal Reserve Bank of San Francisco of $53.2 million, of which there were no advances or borrowings outstanding. The Bank also maintains advance lines with Zions Bank, Wells Fargo Bank, US Bank and Pacific Coast Bankers' Bank to purchase federal funds of up to $43.0 million as of December 31, 2014. At December 31, 2014 we had securities sold under agreement to repurchase of $32.2 million which were secured by investment securities available for sale.

The FHLB functions provide credit for member financial institutions. As a member, we are required to own capital stock in the FHLB and are authorized to apply for advances on the security of such stock and certain of our mortgage loans and other assets (principally securities which are obligations of, or guaranteed by, the United States) provided certain standards related to creditworthiness have been met. Advances are made pursuant to several different programs. Each credit program has its own interest rate and range of maturities. Depending on the program, limitations on the amount of advances are based either on a fixed percentage of an institution's net worth or on the FHLB's assessment of the institution's creditworthiness. Under its current credit policies, the FHLB of Seattle limits advances to 20% of the Bank's assets.

There were no FHLB advances or federal funds purchased for the years ended December 31, 2014, 2013 or 2012.

Supervision and Regulation

We are subject to extensive Federal and Washington State legislation, regulation, and supervision. These laws and regulations are primarily intended to protect depositors, the FDIC and shareholders. The laws and regulations affecting banks and bank holding companies have changed significantly particularly in connection with the enactment

of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank Act”). Among other changes, the Dodd-Frank Act established the Consumer Protection Financial Bureau (“CFPB”) as an independent bureau of the Board of Governors of the Federal Reserve System (“Federal Reserve”). The CFPB assumed responsibility for the implementation of the federal financial consumer protection and fair lending laws and regulations and has authority to impose new requirements. See “—Other Regulatory Developments—The Dodd-Frank Act” herein for a discussion of this legislation. Any change in applicable laws, regulations, or regulatory policies may have a material effect on our business, operations, and prospects. We cannot predict the nature or the extent of the effects on our business and earnings that any fiscal or monetary policies or new Federal or State legislation may have in the future.

The following is a summary discussion of certain laws and regulations applicable to Heritage Financial and Heritage Bank which is qualified in its entirety by reference to the actual laws and regulations.

Heritage Financial. As a registered bank holding company with the Federal Reserve, we are subject to comprehensive regulation and supervision under the Bank Holding Company Act of 1956, as amended. This regulation and supervision is generally intended to ensure that we limit our activities to those allowed by law and that we operate in a safe and sound manner without endangering the financial health of Heritage Bank. As a bank holding company supervised by the Federal Reserve, we are required to file annual and periodic reports with the Federal Reserve and provide additional information as the Federal Reserve may require. The Federal Reserve may examine us, and any of our subsidiaries, and assess us for the cost of such examination.

The Federal Reserve has extensive enforcement authority over bank holding companies, including the ability to assess civil money penalties and to issue cease and desist or removal orders. The Federal Reserve may also order termination of non-banking activities by non-banking subsidiaries of bank holding companies, or divestiture of ownership and control of a non-banking subsidiary by a bank holding company. Some violations may also result in criminal penalties.

Federal Reserve policy provides that a bank holding company is required to serve as a source of financial and managerial strength to its subsidiary banks and may not conduct its operations in an unsafe or unsound manner. Federal Reserve policy further provides that in its capacity as a source of strength to its subsidiary banks, a bank holding company should have the ability to provide financial assistance to its subsidiary banks during periods of financial distress. A bank holding company’s failure to meet its obligation to serve as a source of strength to its subsidiary banks is generally considered by the Federal Reserve to be an unsafe and unsound banking practice or a violation of the Federal Reserve’s regulations or both. The Dodd-Frank Act also extends the "source of strength" doctrine and requires the issuance of implementing regulations by the federal banking regulatory agencies.

Under the prompt corrective action provisions of the Federal Deposit Insurance Act ("FDIA"), a bank holding company with an undercapitalized subsidiary bank must guarantee, within limitations, the capital restoration plan that is required to be implemented of its undercapitalized subsidiary bank. If an undercapitalized subsidiary bank fails to file an acceptable capital restoration plan or fails to implement an accepted plan the Federal Reserve may prohibit the bank holding company or its undercapitalized subsidiary bank from, among other restrictions, paying any dividend or making any other form of capital distribution without the prior approval of the Federal Reserve. In addition, the Federal Reserve policy provides that a bank holding company may pay cash dividends only to the extent that the company’s net income for the past year is sufficient to cover both the cash dividend and a rate of earnings retention that is consistent with the company’s capital needs, asset quality and overall financial condition. In addition, under Washington corporate law, companies generally may not pay dividends if after that payment the company would not be able to pay its liabilities as they become due in the usual course of business, or its total assets would be less than its total liabilities.

We, and any subsidiaries which we may control, are considered “affiliates” within the meaning of the Federal Reserve Act, and transactions between our bank subsidiary and affiliates are subject to numerous restrictions. With some exceptions, we and our subsidiaries are prohibited from tying the provision of various products or services, such as extensions of credit, to other products or services offered by us, or our affiliates.

Bank regulations require bank holding companies and banks to maintain a minimum “leverage” ratio of core capital to adjusted quarterly average total assets of at least 4%. In addition, banking regulators have adopted risk-based capital

guidelines under which risk percentages are assigned to various categories of assets and off-balance sheet items to calculate a risk-adjusted capital ratio. Tier 1 capital generally consists of common stockholders' equity (which does not include unrealized gains and losses on investment securities available for sale), less goodwill and certain identifiable intangible assets. Tier 2 capital includes Tier 1 capital plus the allowance for loan losses and subordinated debt, both subject to some limitations. Regulatory risk-based capital guidelines require Tier 1 capital of 4% of risk-adjusted assets and minimum total capital ratio (combined Tier 1 and Tier 2) of 8% of risk-adjusted assets. In July 2013, the Federal Reserve and the FDIC approved a new rule that will substantially amend the regulatory risk-based capital rules to implement the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act.

For additional information, see "—Capital Adequacy" below.
Subsidiary Bank. Heritage Bank is a Washington-chartered commercial bank, the deposits of which are insured by the FDIC. Heritage Bank is subject to regulation by the FDIC and the Division.
Applicable Federal and State statutes and regulations which govern a bank's operations relate to minimum capital requirements, required reserves against deposits, investments, loans, legal lending limits, mergers and consolidation, borrowings, issuance of securities, payment of dividends, establishment of branches, and other aspects of its operations, among other things. The Division and the FDIC also have authority to prohibit banks under their supervision from engaging in what they consider to be unsafe and unsound practices.
The Bank is required to file periodic reports with the FDIC and the Division, and is subject to periodic examinations and evaluations by those regulatory authorities. Based upon these evaluations, the regulators may revalue the assets of an institution and require that it establish specific reserves to compensate for the differences between the determined value and the book value of such assets. These examinations must be conducted every 12 months, except that well-capitalized banks may be examined every 18 months. The FDIC and the Division may each accept the results of an examination by the other in lieu of conducting an independent examination.
Dividends paid by the Bank provide substantially all of our cash flow. Applicable Federal and Washington State regulations restrict capital distributions by our Bank, including dividends. Such restrictions are tied to the institution's capital levels after giving effect to such distributions. For an additional discussion of restrictions on the payment of dividends, see "Item 5. Market for the Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities" herein.
Capital Adequacy. The Federal Reserve and FDIC have issued substantially similar risk-based and leverage capital guidelines applicable to bank holding companies and banks. In addition, these regulatory agencies may from time to time require that a bank holding company or bank maintain capital above the minimum levels, based on its financial condition or actual or anticipated growth.
The Federal Reserve's risk-based guidelines for bank holding companies establish a two-tier capital framework. Tier 1 capital generally consists of common stockholders' equity (which does not include unrealized gains and losses on investment securities available for sale), less goodwill and certain identifiable intangible assets. Tier 2 capital includes Tier 1 capital plus the allowance for loan losses and subordinated debt, both subject to some limitations. The sum of Tier 1 and Tier 2 capital represents qualifying total capital, at least 50% of which must consist of Tier 1 capital.
Risk-based capital ratios are calculated by dividing Tier 1 and total capital by risk-weighted assets. Assets and off-balance sheet exposures are assigned to one of four categories of risk-weights, based primarily on relative credit risk. The minimum Tier 1 risk- based capital ratios under these guidelines at December 31, 2014 were 4% and 8%, respectively. At December 31, 2014, we had consolidated Tier 1 risk-based capital and total risk-based capital of 13.9% and 15.1%, respectively.
The Federal Reserve's leverage capital guidelines establish a minimum leverage ratio determined by dividing Tier 1 capital by adjusted average total assets. The minimum leverage ratio is 3% for bank holding companies that meet certain specified criteria, including having the highest regulatory rating. All other bank holding companies generally are required to maintain a leverage ratio of at least 4%. At December 31, 2014, we had a consolidated leverage ratio of 10.2%.
In July 2013, the Federal banking regulators approved a final rule to implement the revised capital adequacy standards of the Basel Committee on Banking Supervision, commonly called Basel III, and to address relevant provisions of the Dodd-Frank Act. The final rule includes new risk-based capital and leverage ratios, which are effective January 1, 2015, and revise the definition of what constitutes "capital" for purposes of calculating those ratios. The proposed new minimum capital level requirements applicable to the Company and the Bank will be: (i) a new common equity Tier 1 capital ratio of 4.5%; (ii) a Tier 1 capital ratio of 6% (increased from 4%); (iii) a total capital ratio of 8% (unchanged from current rules); and (iv) a Tier 1 leverage ratio of 4% for all institutions. The rule eliminates the inclusion of certain instruments, such as trust preferred securities, from Tier 1 capital. Instruments issued prior to May 19, 2010 will be grandfathered for companies with consolidated assets of $15 billion or less. The rule also establishes a "capital conservation buffer" of 2.5% above the new regulatory minimum capital requirements, which must consist entirely of

common equity Tier 1 capital and would result in the following minimum ratios: (i) a common equity Tier 1 capital ratio of 7.0%, (ii) a Tier 1 capital ratio of 8.5%, and (iii) a total capital ratio of 10.5%. The new capital conservation buffer requirement will be phased in beginning in January 2016 at 0.625% of risk-weighted assets and would increase by that amount each year until fully implemented in January 2019. An institution would be subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the buffer amount. These limitations would establish a maximum percentage of eligible retained income that could be utilized for such actions.

The FDIC may impose additional restrictions on institutions that are undercapitalized and generally is authorized to reclassify an institution into a lower capital category and impose the restrictions applicable to such category if the institution is engaged in unsafe or unsound practices or is in an unsafe or unsound condition. An institution is deemed "well capitalized" if it has at least a 5.0% Tier 1 capital ratio, a 6.0% Tier 1 risk-based capital ratio and 10.0% total risk-based capital ratio. At December 31, 2014, the Bank's current capital levels exceed the required capital amounts to be considered "well capitalized" and we believe it also meets the fully-phased in minimum capital requirements, including the related capital conservation buffers, as required by the Basel III capital rules.

For a complete description of the Company's and the Bank's required and actual capital levels as of December 31, 2014, see Note 23 - Regulatory Capital Requirements of the Notes to Consolidated Financial Statements included in "Item 8. Financial Statements and Supplementary Data."

Prompt Corrective Action. Federal statutes establish a supervisory framework based on five capital categories: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. An institution's category depends upon where its capital levels are in relation to relevant capital measures, which include a risk-based capital measure, a leverage ratio capital measure and certain other factors. The federal banking agencies have adopted regulations that implement this statutory framework. Under these regulations, an institution is treated as well capitalized if its ratio of total capital to risk-weighted assets is 10% or more, its ratio of core capital to risk-weighted assets is 6% or more, its ratio of core capital to adjusted total assets (leverage ratio) is 5% or more, and it is not subject to any federal supervisory order or directive to meet a specific capital level. In order to be adequately capitalized, an institution must have a total risk-based capital ratio of not less than 8%, a core capital to risk-weighted assets ratio of not less than 4%, and a leverage ratio of not less than 4%. An institution that is not well capitalized is subject to certain restrictions on brokered deposits, including restrictions on the rates it can offer on its deposits generally. Any institution which is neither well capitalized nor adequately capitalized is considered undercapitalized. Undercapitalized institutions are subject to certain prompt corrective action requirements, regulatory controls and restrictions which become more extensive as an institution becomes more severely undercapitalized. Failure by Heritage Bank to comply with applicable capital requirements would, if unremedied, result in progressively more severe restrictions on its activities and lead to enforcement actions, including, but not limited to, the issuance of a capital directive to ensure the maintenance of required capital levels and, ultimately, the appointment of the FDIC as receiver or conservator. Banking regulators will take prompt corrective action with respect to depository institutions that do not meet minimum capital requirements. Additionally, approval of any regulatory application filed for their review may be dependent on compliance with capital requirements.

As of December 31, 2014, the Bank met the requirements to be classified as "well capitalized." See Note 23 - Regulatory Capital Requirements of the Notes to Consolidated Financial Statements included in "Item 8. Financial Statements and Supplementary Data."

Federal law generally bars institutions which are not well capitalized from soliciting or accepting brokered deposits bearing interest rates significantly higher than prevailing market rates.

The recently adopted final rule to strengthen regulatory capital standards will adjust the prompt corrective action categories accordingly.

Deposit Insurance and Other FDIC Programs. The deposits of the Bank are insured up to applicable limits by the Deposit Insurance Fund ("DIF"), which is administered by the FDIC. The FDIC is an independent federal agency that insures the deposits, up to applicable limits, of depository institutions. As insurer of the Bank's deposits, the FDIC has supervisory and enforcement authority over Heritage Bank and this insurance is backed by the full faith and credit of the United States government. As insurer, the FDIC imposes deposit insurance premiums and is authorized to conduct examinations of and to require reporting by institutions insured by the FDIC. It also may prohibit any institution insured by the FDIC from engaging in any activity determined by regulation or order to pose a serious risk to the institution and the DIF. The FDIC also has the authority to initiate enforcement actions and may terminate the deposit insurance if it determines that an institution has engaged in unsafe or unsound practices or is in an unsafe or unsound condition.

The Dodd-Frank Act requires the FDIC's deposit insurance assessments to be based on assets instead of deposits. The FDIC issued rules under which the assessment base for a bank is equal to its total average consolidated assets less average tangible capital. The FDIC assessment rates range from approximately five basis points to 35 basis points, depending on applicable adjustments for unsecured debt issued by an institution and brokered deposits (and to further adjustment for institutions that hold unsecured debt of other FDIC-insured institutions), until such time as the FDIC's reserve ratio equals 1.15%. Once the FDIC's reserve ratio reaches 1.15% and the reserve ratio for the immediately prior assessment period is less than 2.0%, the applicable assessment rates may range from three basis

points to 30 basis points (subject to adjustments as described above). If the reserve ratio for the prior assessment period is equal to, or greater than 2.0% and less than 2.5%, the assessment rates may range from two basis points to 28 basis points and if the prior assessment period is greater than 2.5%, the assessment rates may range from one basis point to 25 basis points (in each case subject to adjustments as described above). No institution may pay a dividend if it is in default on its federal deposit insurance assessment.

As insurer, the FDIC is authorized to conduct examinations of and to require reporting by FDIC-insured institutions. It also may prohibit any FDIC-insured institution from engaging in any activity the FDIC determines by regulation or order to pose a serious threat to the DIF. The FDIC also has the authority to take enforcement actions against banks and savings associations.

Other Regulatory Developments. Significant federal banking legislation has been enacted in recent years. The following summarizes some of the recent significant federal banking legislation.

The Dodd-Frank Act: The Dodd-Frank-Act imposes new restrictions and an expanded framework of regulatory oversight for financial institutions, including depository institutions and implements new capital regulations that we will become subject to and that are discussed above under "- Capital Adequacy."

The federal banking and securities regulators have issued final rules to implement Section 619 of the Dodd-Frank Act (the "Volcker Rule") pursuant to the Dodd-Frank Act. Generally, subject to a transition period and certain exceptions, the Volcker Rule restricts insured depository institutions and their affiliated companies from engaging in short-term proprietary trading of certain securities, investing in funds with collateral comprised of less than 100% loans that are not registered with the Securities and Exchange Commission ("SEC") and from engaging in hedging activities that do not hedge a specific identified risk. After the transition period, the Volcker Rule prohibitions and restrictions will apply to banking entities, including the Company, unless an exception applies. We are continuously reviewing our investment portfolio to determine if changes to our investment strategies may be required in order to comply with the various provisions of the Volcker Rule regulations.

In addition, among other changes, the Dodd-Frank Act requires public companies, like us, to (i) provide their shareholders with a non-binding vote (a) at least once every three years on the compensation paid to executive officers and (b) at least once every six years on whether they should have a "say on pay" vote every one, two or three years; (ii) have a separate, non-binding shareholder vote regarding golden parachutes for named executive officers when a shareholder vote takes place on mergers, acquisitions, dispositions or other transactions that would trigger the parachute payments; (iii) provide disclosure in annual proxy materials concerning the relationship between the executive compensation paid and the financial performance of the issuer; and (iv) amend Item 402 of Regulation S-K to require companies to disclose the ratio of the Chief Executive Officer's annual total compensation to the median annual total compensation of all other employees. For certain of these changes, the implementing regulations have not been promulgated, so the full impact of the Dodd-Frank Act on public companies cannot be determined at this time.

Sarbanes-Oxley Act. As a public company that files periodic reports with the SEC, under the Securities Exchange Act of 1934, Heritage is subject to the Sarbanes-Oxley Act of 2002, which addresses, among other issues, corporate governance, auditing and accounting, executive compensation and enhanced and timely disclosure of corporate information.

The Sarbanes-Oxley Act represents significant federal involvement in matters traditionally left to state regulatory systems, such as the regulation of the accounting profession, and to state corporate law, such as the relationship between a board of directors and management and between a board of directors and its committees. Our policies and procedures have been updated to comply with the requirements of the Sarbanes-Oxley Act.

Website Access to Company Reports

We post publicly available reports required to be filed with the SEC on our website, www.HF-WA.com, as soon as reasonably practicable after filing such reports with the SEC. The required reports are available free of charge through our website.

Code of Ethics

We have adopted a Code of Ethics that applies to our principal executive officer, principal financial officer and controller. We have posted the text of our code of ethics at www.HF-WA.com in the section titled Investor

Information: Corporate Governance. Any waivers of the code of ethics will be publicly disclosed to shareholders.

Competition

We compete for loans and deposits with other commercial banks, credit unions, mortgage bankers, and other institutions in the scope and type of services offered, interest rates paid on deposits, pricing of loans, and number and locations of branches, among other things. Many of our competitors have substantially greater resources than we do.

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Particularly in times of high or rising interest rates, we also face significant competition for investors' funds from short-term money market securities and other corporate and government securities.

We compete for loans principally through the range and quality of the services we provide, interest rates and loan fees, and the locations of our Bank's branches. We actively solicit deposit-related clients and compete for deposits by offering depositors a variety of savings accounts, checking accounts, cash management and other services.

Employees

We had 748 full-time equivalent employees at December 31, 2014. We believe that employees play a vital role in the success of a service company. Employees are provided with a variety of benefits such as medical, vision, dental and life insurance, a retirement plan, and paid vacations and sick leave. None of our employees are covered by a collective bargaining agreement.

Executive Officers

The following table sets forth certain information with respect to the executive officers of the Company at December 31, 2014.

Name	Age as of December 31, 2014	Position	Has Served the Company or Heritage Bank Since
Brian L. Vance	60	President and Chief Executive Officer of Heritage; Chief Executive Officer of Heritage Bank	1996
Jeffrey J. Deuel	56	Executive Vice President, Heritage; President and Chief Operating Officer of Heritage Bank	2010
Donald J. Hinson	53	Executive Vice President and Chief Financial Officer of Heritage and Heritage Bank	2005
David A. Spurling	61	Executive Vice President and Chief Credit Officer of Heritage and Heritage Bank	1999
Bryan McDonald (1)	43	Executive Vice President and Chief Lending Officer of Heritage Bank	2014

(1) Former executive officer of Washington Banking Company.

The business experience of each executive officer is set forth below.

Brian L. Vance is the President and Chief Executive Officer of Heritage and Chief Executive Officer of Heritage Bank as well as a director of Heritage. Mr. Vance was appointed President and Chief Executive Officer of Heritage and Heritage Bank in 2006. In 2003, Mr. Vance was appointed President and Chief Executive Officer of Heritage Bank and in 1998, Mr. Vance was named President and Chief Operating Officer of Heritage Bank. Mr. Vance joined Heritage Bank in 1996 as its Executive Vice President and Chief Credit Officer. Prior to joining Heritage Bank, Mr. Vance was employed for 24 years with West One Bank, a bank with offices in Idaho, Utah, Oregon and Washington. Prior to leaving West One, he was Senior Vice President and Regional Manager of Banking Operations for the south Puget Sound region.

Jeffrey J. Deuel was promoted to President and Chief Operating Officer of Heritage Bank and Executive Vice President of Heritage in September 2012. In November 2010, Mr. Deuel was named Executive Vice President and Chief Operating Officer of Heritage Bank and Executive Vice President of the Company. Mr. Deuel joined Heritage Bank in February 2010 as Executive Vice President. Mr. Deuel came to the Company with 28 years of banking experience and most recently held the position of Executive Vice President Commercial Operations with JPMorgan Chase, formerly Washington Mutual. Prior to joining Washington Mutual Mr. Deuel was based in Philadelphia where he worked for Bank United, First Union Bank, CoreStates Bank, and First Pennsylvania Bank. During his career Mr. Deuel held a variety of leadership positions in commercial banking including lending, retail and support services,

corporate strategies, credit administration, and portfolio management. He earned his Bachelor’s degree at Gettysburg College.

Donald J. Hinson became Executive Vice President and Chief Financial Officer of Heritage and Heritage Bank in September 2012. In 2007, Mr. Hinson was appointed the Senior Vice President and Chief Financial Officer of Heritage and Heritage Bank. Mr. Hinson joined Heritage Bank in 2005 as Vice President and Controller. Prior to that, he served

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in the banking audit practice of local and national accounting firms of Knight, Vale and Gregory and RSM McGladrey from 1994 to 2005. Mr. Hinson holds a Bachelors of Science degree in Accounting from Central Washington University and is a licensed Certified Public Accountant.
David A. Spurling became Executive Vice President and Chief Credit Officer of Heritage and Heritage Bank in January 2014. Prior to that, he was the Senior Vice President and Chief Credit Officer of Heritage Bank beginning in 2007. Mr. Spurling joined Heritage Bank in 2001 as a commercial lender, followed by a role as a commercial team leader. He began his banking career as a middle market lender at Seafirst Bank, followed by positions as a commercial lender at Bank of America in Small Business Banking and as a regional manager for Bank of America's government-guaranteed lending division. Mr. Spurling holds a Master's Degree in Business Administration from the University of Washington and is Credit Risk Certified by the Risk Management Association.
Bryan McDonald became Executive Vice President and Chief Lending Officer of Heritage Bank upon completion of the Washington Banking Merger effective on May 1, 2014. Prior to that, Mr. McDonald was President and Chief Executive Officer of Whidbey Island Bank since January 1, 2012. Mr. McDonald joined Whidbey Island Bank in 2006 as Commercial Banking Manager and he served as Senior Vice President and Chief Operating Officer of Whidbey Island Bank from April 1, 2010 until his promotion to Executive Vice President on August 26, 2010. Mr. McDonald has been serving in the banking industry since 1994, including in regional commercial lending management roles since 1996 for Washington Mutual and Peoples Bank. Mr. McDonald holds a Bachelor's and Master's Degree in Business Administration from Washington State University.

ITEM 1A. RISK FACTORS

We assume and manage a certain degree of risk in order to conduct our business strategy. The following provides a discussion of certain risks that management believes are specific to our business. This discussion should not be viewed as an all inclusive list or in any particular order.
Our strategy of pursuing acquisitions and de novo branching exposes us to financial and operational risks that could adversely affect us.
We are pursuing a strategy of supplementing organic growth by acquiring other financial institutions or their businesses that we believe will help us fulfill our strategic objectives and enhance our earnings. There are risks associated with this strategy, however, including the following:

- we may be exposed to potential asset quality issues or unknown or contingent liabilities of the banks, businesses, assets and liabilities we acquire. If these issues or liabilities exceed our estimates, our results of operations and financial condition may be materially negatively affected;
- prices at which acquisitions can be made fluctuate with market conditions. We have experienced times during which acquisitions could not be made in specific markets at prices we considered acceptable and expect that we may continue to experience this condition in the future;
- the acquisition of other entities generally requires integration of systems, procedures and personnel of the acquired entity into our company to make the transaction economically successful. This integration process is complicated and time consuming and can also be disruptive to the customers of the acquired business. If the integration process is not conducted successfully and with minimal effect on the acquired business and its customers, we may not realize the anticipated economic benefits of an acquisition within the expected time frame, and we may lose customers or employees of the acquired business. We may also experience greater than anticipated customer losses even if the integration process is successful. These risks are present in our completed FDIC-assisted transactions involving our assumption of deposits and the acquisition of assets of Cowlitz Bank and Pierce Commercial Bank in July 2010 and November 2010, respectively; and in the completed open-bank acquisitions of NCB and Valley Community Bancshares in January 2013 and July 2013, respectively, and in the merger of Washington Banking Company in May 2014;
- to finance an acquisition, we may borrow funds, thereby increasing our leverage and diminishing our liquidity, or raise additional capital, which could dilute the interests of our existing shareholders;
-

we completed two acquisitions during 2010, two acquisitions during 2013 and one merger in 2014 that enhanced our rate of growth. We may not be able to continue to sustain our past rate of growth or to grow at all in the future;

- we expect our net income will increase following our acquisitions, however, we also expect our general and administrative expenses and consequently our efficiency ratios will also increase. Ultimately, we would expect our efficiency ratio to improve; however, if we are not successful in our integration

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process, this may not occur, and our acquisitions or branching activities may not be accretive to earnings in the short or long-term; and

- the purchase and assumption agreement and the shared-loss agreements we entered into with the FDIC in connection with the Cowlitz Acquisition and the Pierce Acquisition, have specific, detailed and cumbersome compliance, servicing, notification and reporting requirements. Our failure to comply with the terms of the agreements or to properly service the loans and real estate owned under the requirements of the shared-loss agreements may cause individual loans or large pools of loans to lose eligibility for shared-loss payments from the FDIC. This could result in material losses that are currently not anticipated.

Our business strategy includes significant growth plans, and our financial condition and results of operations could be negatively affected if we are not successful in executing this strategy or if we fail to grow or manage our growth effectively.

We intend to pursue a significant growth strategy for our business. We regularly evaluate potential acquisitions and expansion opportunities. If appropriate opportunities present themselves, we expect to engage in selected acquisitions of financial institutions in the future, including branch acquisitions, or other business growth initiatives or undertakings. There can be no assurance that we will successfully identify appropriate opportunities, that we will be able to negotiate or finance such activities or that such activities, if undertaken, will be successful.

Our growth initiatives may require us to recruit experienced personnel to assist in such initiatives, which will increase our compensation costs. In addition, the failure to identify and retain such personnel would place significant limitations on our ability to successfully execute our growth strategy. To the extent we expand our lending beyond our current market areas, we also could incur additional risk related to those new market areas. We may not be able to expand our market presence in our existing market areas or successfully enter new markets.

If we do not successfully execute our acquisition growth plan, it could adversely affect our business, financial condition, results of operations, reputation and growth prospects. In addition, if we were to conclude that the value of an acquired business had decreased and that the related goodwill had been impaired, that conclusion would result in an impairment of goodwill charge to us, which would adversely affect our results of operations. While we believe we have the executive management resources and internal systems in place to successfully manage our future growth, there can be no assurance that suitable growth opportunities will be available or that we will successfully manage our growth. See “-If the goodwill we have recorded in connection with acquisitions becomes impaired, our earnings and capital could be reduced” and “-Our strategy of pursuing acquisitions and de novo branching exposes us to financial and operational risks that could adversely affect us” for additional risks related to our acquisition strategy.

We operate in a highly regulated environment and may be adversely affected by changes in federal and state laws and regulations.

The financial services industry is extensively regulated. We are subject to extensive examination, supervision and comprehensive regulation by the Federal Reserve and Heritage Bank is subject to examination, supervision and comprehensive regulation by the FDIC and the Division. The Federal Reserve, FDIC and Division govern the activities in which we may engage, primarily for the protection of depositors and the Deposit Insurance Fund. These regulatory authorities have extensive discretion in connection with their supervisory and enforcement activities, including the ability to impose requirements for additional capital, restrictions on operations, the reclassification of assets, and the determination of the adequacy of the allowance for loan losses and level of deposit insurance premiums assessed. In addition, these bank regulators also have the ability to impose additional conditions in the approval of merger and acquisition transactions.

As discussed under “Item 1. Business - Supervision and Regulation - Capital Adequacy” of this Form 10-K, the Dodd-Frank Act has significantly changed the bank regulatory structure and will affect the lending, deposit, investment, trading and operating activities of financial institutions and their holding companies. The Dodd-Frank Act requires various federal agencies to adopt a broad range of new implementing rules and regulations, and to prepare numerous studies and reports for Congress. The federal agencies are given significant discretion in drafting and implementing rules and regulations, and consequently, many of the details and much of the impact of the Dodd-Frank Act may not be known for many months or years. It is difficult at this time to predict when or how any new standards

will ultimately be applied to us or what specific impact the Dodd-Frank Act and the yet to be written implementing rules and regulations will have on community banks. However, it is expected that at a minimum they will increase our operating and compliance costs and could increase our noninterest expense.

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We may face increased compliance costs and uncertainty in residential mortgage lending as a result of the adoption of consumer protection regulations by the Consumer Financial Protection Bureau.

The Dodd Frank Act created a new Consumer Financial Protection Bureau ("CFPB") with broad powers to supervise and enforce consumer protection laws. The CFPB has broad rule-making authority for a wide range of consumer protection laws that apply to all banks and savings institutions, including the authority to prohibit "unfair, deceptive or abusive" acts and practices. The CFPB has issued a rule designed to clarify for lenders how they can avoid monetary damages under the Dodd-Frank Act, which would hold lenders accountable for ensuring a borrower's ability to repay a mortgage. Loans that meet this "qualified mortgage" definition will be presumed to have complied with the new ability-to-repay standard. Under the CFPB's rule, a "qualified mortgage" loan must not contain certain specified features, including:

- excessive upfront points and fees (those exceeding 3% of the total loan amount, less "bona fide discount points" for prime loans);
- interest-only payments;
- negative-amortization; and
- terms longer than 30 years.

Also, to qualify as a "qualified mortgage," a borrower's total debt-to-income ratio may not exceed 43%. Lenders must also verify and document the income and financial resources relied upon to qualify the borrower for the loan and underwrite the loan based on a fully amortizing payment schedule and maximum interest rate during the first five years, taking into account all applicable taxes, insurance and assessments. The CFPB's rule on qualified mortgages could limit our ability or desire to make certain types of loans or loans to certain borrowers, or could make it more expensive and/or time consuming to make these loans, which could limit our growth or profitability.

Our loan portfolio is concentrated in loans with a higher risk of loss.

Repayment of our commercial business loans, consisting of commercial and industrial loans as well as owner-occupied and non-owner occupied commercial real estate loans, is often dependent on the cash flows of the borrower, which may be unpredictable, and the collateral securing these loans may fluctuate in value. We offer different types of commercial loans to a variety of businesses with a focus on real estate related industries and businesses in agricultural, healthcare, legal, and other professions. The types of commercial loans offered are business lines of credit, term equipment financing and term real estate loans. We also originate loans that are guaranteed by the Small Business Administration, or SBA, and are a "preferred lender" of the SBA. Commercial business lending involves risks that are different from those associated with real estate lending. Real estate lending is generally considered to be collateral based lending with loan amounts established on predetermined loan to collateral values and liquidation of the underlying real estate collateral being viewed as the primary source of repayment in the event of borrower default. Our commercial business loans are primarily made based on our assessment of the cash flow of the borrower and secondarily on the underlying collateral provided by the borrower. The borrower's cash flow may be unpredictable, and collateral securing these loans may fluctuate in value. Although commercial business loans are often collateralized by equipment, inventory, accounts receivable or other business assets, the liquidation of collateral in the event of default is often an insufficient source of repayment because accounts receivable may be uncollectible and inventories may be obsolete or of limited use, among other things. Accordingly, the repayment of commercial business loans depends primarily on the cash flow and creditworthiness of the borrower and secondarily on the underlying collateral provided by the borrower. In addition, as part of our commercial business lending activities, we originate agricultural loans. Payments on agricultural loans are typically dependent on the profitable operation or management of the related farm property. The success of the farm may be affected by many factors outside the control of the borrower, including adverse weather conditions that prevent the planting of a crop or limit crop yields, declines in market prices for agricultural products and the impact of government regulations. In addition, many farms are dependent on a limited number of key individuals whose injury or death may significantly affect the successful operation of the farm. If the cash flow from a farming operation is diminished, the borrower's ability to repay the loan may be impaired.

At December 31, 2014, our noncovered commercial business loans (consisting of commercial and industrial loans, owner-occupied commercial real estate loans and non-owner occupied commercial real estate loans) totaled $1.70 billion, or approximately 80.2% of our total noncovered loan portfolio. Approximately $4.7 million, or 0.3%, of our total noncovered commercial business loans were nonperforming at December 31, 2014. The majority of the nonperforming commercial business loans were commercial and industrial loans.

Our non-owner occupied commercial real estate loans, which includes five or more family residential real estate loans, involve higher principal amounts than other loans and repayment of these loans may be dependent on factors outside our control or the control of our borrowers. We originate commercial and five or more family residential real estate loans for individuals and businesses for various purposes, which are secured by commercial properties.

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These loans typically involve higher principal amounts than other types of loans, and repayment is dependent upon income generated, or expected to be generated, by the property securing the loan in amounts sufficient to cover operating expenses and debt service, which may be adversely affected by changes in the economy or local market conditions. For example, if the cash flow from the borrower's project is reduced as a result of leases not being obtained or renewed, the borrower's ability to repay the loan may be impaired.

Commercial and five or more family residential real estate loans also expose us to greater credit risk than loans secured by residential real estate because the collateral securing these loans typically cannot be sold as easily as residential real estate. In addition, many of our commercial and five or more family residential real estate loans are not fully amortizing and contain large balloon payments upon maturity. Such balloon payments may require the borrower to either sell or refinance the underlying property in order to make the payment, which may increase the risk of default or non-payment. If we foreclose on a commercial and five or more family residential real estate loan, our holding period for the collateral typically is longer than for one-to-four family residential loans because there are fewer potential purchasers of the collateral. Additionally, commercial and five or more family residential real estate loans generally have relatively large balances to single borrowers or related groups of borrowers. Accordingly, if we make any errors in judgment in the collectability of our commercial and five or more family residential real estate loans, any resulting charge-offs may be larger on a per loan basis than those incurred with our residential or consumer loan portfolios.

As of December 31, 2014, our non-owner occupied commercial real estate loans totaled $616.8 million, or 29.0% of our total noncovered loan portfolio.

Our real estate construction and land development loans are based upon estimates of costs and value associated with the completed project. These estimates may be inaccurate. Construction lending can involve a higher level of risk than other types of lending because funds are advanced partially based upon the value of the project, which is uncertain prior to the project's completion. Because of the uncertainties inherent in estimating construction costs as well as the market value of a completed project and the effects of governmental regulation of real property, our estimates with regards to the total funds required to complete a project and the related loan-to-value ratio may vary from actual results. As a result, construction loans often involve the disbursement of substantial funds with repayment dependent, in part, on the success of the ultimate project and the ability of the borrower to sell or lease the property or refinance the indebtedness. If our estimate of the value of a project at completion proves to be overstated, it may have inadequate security for repayment of the loan and may incur a loss.

As of December 31, 2014, our noncovered real estate construction and land development loans totaled $108.1 million, or 5.1% of our total noncovered loan portfolio. Of these loans, $46.7 million, or 2.2% of our total noncovered loan portfolio, were one-to-four family residential construction related and $61.4 million, or 2.9% of our total noncovered loan portfolio, were five-or-more family residential and commercial property construction related. Approximately $2.7 million, or 2.5%, of our total noncovered construction loans were nonperforming at December 31, 2014.

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

Lending money is a substantial part of our business. Every loan carries a certain risk that it will not be repaid in accordance with its terms or that any underlying collateral will not be sufficient to assure repayment. This risk is affected by, among other things:

- cash flow of the borrower and/or the project being financed;
- the changes and uncertainties as to the future value of the collateral, in the case of a collateralized loan;
- the character and creditworthiness of a particular borrower;
- changes in economic and industry conditions; and
- the duration of the loan.

We maintain an allowance for loan losses on our loans, which is a reserve established through a provision for loan losses charged against earnings, which we believe is appropriate to absorb known and inherent losses in our loan portfolio. The amount of this allowance is determined by our management through a periodic review and consideration of several factors, including, but not limited to:

- our general reserve, based on our historical default and loss experience;

- our specific reserve, based on our evaluation of nonperforming loans and their underlying collateral or discounted cash flows; and
- current macroeconomic factors and management's expectation of future events.

The determination of the appropriate level of the allowance for loan losses inherently involves a high degree of subjectivity and requires us to make significant estimates of current credit risks and future trends, all of which may undergo material changes. Deterioration in economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside of our control, may

require an increase in the allowance for loan losses. If current conditions in the housing and real estate markets weaken, we expect we will experience increased delinquencies and credit losses. In addition, bank regulatory agencies periodically review our allowance for loan losses and may require an increase in the provision for possible loan losses or the recognition of further loan charge-offs, based on judgments different than those of management. In addition, if charge-offs in future periods exceed the allowance for loan losses we will need additional provisions to increase the allowance for loan losses. Any increases in the allowance for loan losses will result in a decrease in net income and possibly capital, and may have a material adverse effect on our financial condition and results of operations.

If our allowance for loan losses is not adequate, we may be required to make further increases in our provision for loan losses and to charge-off additional loans, which could adversely affect our results of operations and our capital.

For the year ended December 31, 2014 we recorded a total provision for loan losses of $4.6 million compared to $3.7 million for the year ended December 31, 2013. The provision related to the noncovered portfolio was $2.2 million and $1.8 million for the years ended December 31, 2014 and 2013, respectively. Our provision for loan losses on covered loans was $2.4 million and $1.9 million for the years ended December 31, 2014 and 2013, respectively. We recorded net loan charge-offs for noncovered loans of $2.7 million for the year ended December 31, 2014 compared to $3.4 million for the year ended December 31, 2013. The net charge-offs for covered loans was $3.0 million and $73,000 for the years ended December 31, 2014 and 2013, respectively. At December 31, 2014 our total nonperforming noncovered loans were $7.5 million, or 0.35% of total noncovered loans, compared to $7.7 million or 0.66% of total noncovered loans at December 31, 2013. Generally, our nonperforming loans and assets reflect operating difficulties of individual borrowers, which may be the result of current economic conditions. If economic conditions deteriorate, we expect that we could experience significantly higher delinquencies and loan charge-offs. As a result, we may be required to make further increases in our provision for loan losses in the future, which could adversely affect our financial condition and results of operations, perhaps materially.

General economic conditions tend to impact loan segments at varying degrees. Our commercial and industrial loan portfolio, which represented 46.1% of our nonaccrual noncovered loans at December 31, 2014, generally has the largest percentage of nonperforming loans as the borrowers are primarily business owners whose business results are influenced by deteriorating economic conditions. Slower sales and excess inventory in the housing market has been the primary cause of deterioration in our one-to-four family residential construction loans, which represented 35.3% of our nonperforming noncovered loans at December 31, 2014.

The current economic condition in the market areas we serve may adversely impact our earnings and could increase the credit risk associated with our loan portfolio.

Substantially all of our loans are to businesses and individuals in the states of Washington and Oregon, and a decline in the economies of our primary market areas of the Pacific Northwest could have a material adverse effect on our business, financial condition, results of operations and prospects.

Weakness or a deterioration in economic conditions in the market areas we serve could result in the following consequences, any of which could have a materially adverse impact on our business, financial condition and results of operations:

- loan delinquencies, problem assets and foreclosures may increase;
- we may increase our provision for loan losses;
- demand for our products and services may decline possibly resulting in a decrease in our total loans;
- collateral for loans made may decline further in value, exposing us to increased risk of loss on existing loans;
- the net worth and liquidity of loan guarantors may decline, impairing their ability to honor commitments to us; and
- the amount of our deposits may decrease and the composition of our deposits may be adversely affected.

If the goodwill we have recorded in connection with acquisitions becomes impaired, our earnings and capital could be reduced.

Accounting standards require that we account for acquisitions using the purchase method of accounting. Under purchase accounting, if the purchase price of an acquired company exceeds the fair value of its net assets, the excess is carried on the acquirer’s balance sheet as goodwill. In accordance with generally accepted accounting principles, our goodwill is evaluated for impairment on an annual basis or more frequently if events or circumstances indicate that a

potential impairment exists. Such evaluation is based on a variety of factors, including the quoted price of our common stock, market prices of common stock of other banking organizations, common stock trading multiples, discounted

cash flows, and data from comparable acquisitions. At December 31, 2014, we had goodwill with a carrying amount of $119.0 million.

Declines in our stock price or a prolonged weakness in the operating environment of the financial services industry may result in a future impairment charge. Any such impairment charge could have a material adverse affect on our operating results and capital.

Fluctuating interest rates can adversely affect our profitability.

Our profitability is dependent to a large extent upon net interest income, which is the difference (or "spread") between the interest earned on loans, securities and other interest earning assets and the interest paid on deposits, borrowings, and other interest bearing liabilities. Because of the differences in maturities and repricing characteristics of our interest earning assets and interest bearing liabilities, changes in interest rates do not produce equivalent changes in interest income earned on interest earning assets and interest paid on interest bearing liabilities. Accordingly, fluctuations in interest rates could adversely affect our interest rate spread, and, in turn, our profitability.

Although management believes it has implemented effective asset and liability management strategies to reduce the potential effects of changes in interest rates on our results of operations, any substantial, unexpected or prolonged change in market interest rates could have a material adverse effect on our financial condition and results of operations. Also, our interest rate risk modeling techniques and assumptions likely may not fully predict or capture the impact of actual interest rate changes on our balance sheet.

Historically low interest rates may adversely affect our net interest income and profitability.

During the past several years it has been the policy of the Federal Reserve to maintain interest rates at historically low levels through its targeted federal funds rate and the purchase of mortgage-backed securities. As a result, market rates on the loans we have originated and the yields on securities we have purchased have been at lower levels than available prior to 2008. As a general matter, our interest bearing liabilities reprice or mature more quickly than our interest earning assets, which has been one factor contributing to the increase in our interest rate spread as interest rates decreased. However, our ability to lower our interest expense will be limited at these interest rate levels while the average yield on our interest earning assets may continue to decrease. The Federal Reserve has recently indicated its intention to maintain low interest rates through at least late 2015. Accordingly, our net interest income may be adversely affected and may decrease, which may have an adverse effect on our profitability.

Decreased volumes and lower gains on sales of mortgage loans sold could adversely impact our noninterest income.

We originate and sell one-to-four family residential loans. Our mortgage banking income is a significant portion of our noninterest income. We generate gains on the sale of one-to-four family residential loans pursuant to programs currently offered by Freddie Mac and other secondary market purchasers. Any future changes in their purchase programs, our eligibility to participate in such programs, the criteria for loans to be accepted or laws that significantly affect the activity of such entities could, in turn, materially adversely affect our results of operations. Further, in a rising or higher interest rate environment, our originations of mortgage loans may decrease, resulting in fewer loans that are available to be sold to investors. This would result in a decrease in mortgage banking revenues and a corresponding decrease in noninterest income. In addition, our results of operations are affected by the amount of noninterest expense associated with mortgage banking activities, such as salaries and employee benefits, occupancy, equipment and data processing expense and other operating costs. During periods of reduced loan demand, our results of operations may be adversely affected to the extent that we are unable to reduce expenses commensurate with the decline in loan originations.

The tightening of available liquidity could limit our ability to replace deposits and fund loan demand, which could adversely affect our earnings and capital levels.

A tightening of the credit markets and the inability to obtain adequate funding to replace deposits and fund continued loan growth may negatively affect asset growth and, consequently, our earnings capability and capital levels. In addition to any deposit growth, maturity of investment securities and loan payments, we rely from time to time on advances from the Federal Home Loan Bank of Seattle, or FHLB, and certain other wholesale funding sources to fund loans and replace deposits. In the event of a further downturn in the economy, these additional funding sources could be negatively affected which could limit the funds available to us. Our liquidity position could be significantly

constrained if we were unable to access funds from the FHLB or other wholesale funding sources.

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Our growth or future losses may require us to raise additional capital in the future, but that capital may not be available when it is needed or the cost of that capital may be very high; further, the resulting dilution of our equity may adversely affect the market price of our common stock.

We are required by federal and state regulatory authorities to maintain adequate levels of capital to support our operations. At some point we may need to raise additional capital to support continued internal growth and growth through acquisitions. Our ability to raise additional capital, however, will depend on conditions in the capital markets at that time, which are outside our control, and on our financial condition and performance. If we are able to raise capital it may not be on terms that are acceptable to us. If we cannot raise additional capital when needed, our ability to further expand our operations through internal growth and acquisitions could be materially impaired and our financial condition and liquidity could be materially and adversely affected. Accordingly, we cannot make assurances that we will be able to raise additional capital when needed.

We are not restricted from issuing additional common stock or preferred stock, including any securities that are convertible into or exchangeable for, or that represent the right to receive, common stock or preferred stock or any substantially similar securities. The market price of our common stock could decline as a result of sales of a large number of shares of common stock or preferred stock or similar securities in the market or from the perception that such sales could occur.

Our Board of Directors is authorized generally to cause us to issue additional common stock, as well as series of preferred stock, without any action on the part of our shareholders except as may be required under the listing requirements of the NASDAQ Stock Market. In addition, our Board has the power, without shareholder approval, to set the terms of any such series of preferred stock that may be issued, including voting rights, dividend rights and preferences over the common stock with respect to dividends or upon the liquidation, dissolution or winding-up of our business and other terms.

In addition, if we issue preferred stock in the future that has a preference over the common stock with respect to the payment of dividends or upon liquidation, dissolution or winding-up, or if we issue preferred stock with voting rights that dilute the voting power of the common stock, the rights of holders of the common stock or the market price of the common stock could be adversely affected.

We rely heavily on the proper functioning of our technology.

We rely heavily on communications and information systems to conduct our business. Any failure, interruption or breach in security of these systems could result in failures or disruptions in our customer relationship management, general ledger, deposit, loan and other systems. While we have policies and procedures designed to prevent or limit the effect of the failure, interruption or security breach of our information systems, there can be no assurance that any such failures, interruptions or security breaches will not occur or, if they do occur, that they will be adequately addressed. The occurrence of any failures, interruptions or security breaches of our information systems could damage our reputation, result in a loss of customer business, subject us to additional regulatory scrutiny, or expose us to civil litigation and possible financial liability, any of which could have a material adverse effect on our financial condition and results of operations.

We rely on third-party service providers for much of our communications, information, operating and financial control systems technology. If any of our third-party service providers experience financial, operational or technological difficulties, or if there is any other disruption in our relationships with them, we may be required to locate alternative sources of such services, and we cannot assure that we could negotiate terms that are as favorable to us, or could obtain services with similar functionality, as found in our existing systems, without the need to expend substantial resources, if at all. Any of these circumstances could have an adverse effect on our business.

Changes in accounting standards may affect how we record and report our performance.

Our accounting policies and methods are fundamental to how we record and report our financial condition and results of operations. From time to time there are changes in the financial accounting and reporting standards that govern the preparation of our financial statements. These changes can be difficult to predict and can materially impact how we report and record our financial condition and results of operations. In some cases, we could be required to apply a new or revised standard retroactively, resulting in a retrospective adjustment to prior financial statements.

We are dependent on key personnel and the loss of one or more of those key personnel may materially and adversely affect our prospects.

Competition for qualified employees and personnel in the banking industry is intense and there are a limited number of qualified persons with knowledge of, and experience in, the community banking industry where we conduct our business. The process of recruiting personnel with the combination of skills and attributes required to carry out our strategies is often lengthy. Our success depends to a significant degree upon our ability to attract and retain qualified

management, loan origination, finance, administrative, marketing and technical personnel and upon the continued contributions of our management and personnel. In particular, our success has been and continues to be highly dependent upon the abilities of key executives, including our President and Chief Executive Officer, Mr. Brian L. Vance, and certain other employees. The loss of key personnel could adversely affect our ability to successfully conduct our business.

ITEM 1B. UNRESOLVED STAFF COMMENTS

The Company has no unresolved staff comments from the Securities and Exchange Commission ("SEC") as it relates to the Company's financial information as reported on Form 10-K.

ITEM 2. PROPERTIES

Our executive offices and the main office of Heritage Bank are located in approximately 22,000 square feet of the headquarters building and adjacent office space and main branch office which are owned by Heritage Bank and located in downtown Olympia. The Company's branch network at December 31, 2014 is comprised of 66 branches located throughout Washington and Oregon counties. The number of branches per county, as well as occupancy type, is detailed in the following table.

			Occupancy Type	
County	State	Number of Branches	Owned	Leased
Clark	WA	2	1	1
Cowlitz	WA	2	2	—
Island	WA	7	5	2
Kittitas	WA	1	—	1
King	WA	8	3	5
Mason	WA	1	1	—
Multnomah	OR	1	—	1
Pierce	WA	13	8	5
San Juan	WA	1	—	1
Skagit	WA	4	3	1
Snohomish	WA	12	6	6
Thurston	WA	5	3	2
Whatcom	WA	4	3	1
Yakima	WA	5	5	—
Total		66	40	26

One Snohomish County branch, one Thurston County branch and the branch in Kittitas County have land leases, which are not included in the leased section above as the building is owned.

For additional information concerning our premises and equipment and lease obligations, see Notes 10 and 17, respectively, of the Notes to Consolidated Financial Statements included in "Item 8. Financial Statements and Supplementary Data."

ITEM 3. LEGAL PROCEEDINGS

Heritage and Heritage Bank, are not a party to any material pending legal proceedings other than ordinary routine litigation incidental to the business of the Bank, other than the matter described below.

On April 4, 2014, Washington Banking, its directors and Heritage entered into and documented an agreement in principle among Washington Banking, its directors, Heritage and the plaintiffs for the settlement of the putative shareholder class action lawsuit captioned In Re Washington Banking Company Shareholder Litigation, Lead Case No. 13-2-38689-5 SEA, pending before the Superior Court of the State of Washington in and for King County (the “Action”). The Action alleges that Washington Banking’s directors breached their fiduciary duties to Washington

Banking and its shareholders in connection with the transactions contemplated by the Agreement and Plan of Merger, dated October 23, 2013 (the "Merger Agreement"), under which Washington Banking and Heritage combined their

organizations in a strategic combination, with Washington Banking merging with and into Heritage. The Action also alleges, among other things, that Heritage aided and abetted the alleged breaches of fiduciary duties by Washington Banking's directors and that the public disclosures concerning the Washington Banking Merger are misleading in various respects.

On December 15, 2014, the Court entered an order preliminarily approving the settlement of the consolidated litigation and ordering WBCO to provide notice of the proposed settlement to those persons who held WBCO shares during the purported class period.

On February 27, 2015, the Court held a hearing to consider whether the settlement was fair and reasonable to the class members and, if so, to approve the settlement and to consider plaintiffs' counsel's application for an award of attorneys' fees and costs from Washington Banking. At the hearing, the Court approved the settlement and entered a Final Judgment and Order of Dismissal With Prejudice awarding plaintiffs' counsel fees and expenses totaling $450,000 and terminating the litigation.

The settlement of the Action did not affect the Washington Banking Merger consideration paid to Washington Banking's shareholders in connection with the completion of the Washington Banking Merger on May 1, 2014. Washington Banking, its directors and Heritage took the position that the Action was without merit and denied any wrongdoing of any kind. Washington Banking, its directors and Heritage entered into the settlement solely to eliminate the costs, risks, burden, distraction and expense of further litigation and to put the claims that were or could have been asserted to rest. Nothing in the stipulation of settlement or any public filing, including this Annual Report on Form 10-K, shall be deemed an admission of the legal necessity of filing or the materiality under applicable laws of any of the additional information contained herein or in any public filing associated with the settlement of the Action.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable

PART II

ITEM 5. MARKET FOR THE REGISTRANTS COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Our common stock is traded on the NASDAQ Global Select Market under the symbol HFWA. At December 31, 2014, we had approximately 1,514 shareholders of record (not including the number of persons or entities holding stock in nominee or street name through various brokerage firms) and 30,259,838 outstanding shares of common stock. This total does not reflect the number of persons or entities who hold stock in nominee or "street" name through various brokerage firms. The last reported sales price on February 25, 2015 was $16.28 per share. The following table provides sales information per share of our common stock as reported on the NASDAQ Global Select Market for the indicated quarters.

	2014 Quarter ended,			
	March 31	June 30	September 30	December 31
High	$18.48	$17.86	$16.96	$17.97
Low	$16.18	$15.44	$15.59	$15.80

For the interim period subsequent to the 2014 fiscal year through the last reported sales price on February 25, 2015, the high and low sales information price per share of our common stock as reported on the NASDAQ Global Selected Market was $17.16 and $15.52, respectively.

	2013 Quarter ended,			
	March 31	June 30	September 30	December 31
High	$15.22	$14.65	$16.45	$17.48
Low	$13.84	$13.25	$14.75	$15.01

Quarterly, the Company reviews the potential payment of cash dividends to common shareholders. The timing and amount of cash dividends paid on our common stock depends on the Company’s earnings, capital requirements, financial condition and other relevant factors.

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The dividend activities for the years ended December 31, 2014 and 2013 and subsequent through the date of this filing are listed below:

Declared	Cash Dividend per Share	Record Date	Paid
January 30, 2013	$0.08	February 8, 2013	February 22, 2013
April 24, 2013	$0.08	May 10, 2013	May 24, 2013
July 23, 2013	$0.18	August 6, 2013	August 15, 2013
October 23, 2013	$0.08	November 5, 2013	November 15, 2013
January 29, 2014	$0.08	February 10, 2014	February 24, 2014
March 27, 2014	$0.08	April 8, 2014	April 23, 2014
July 24, 2014	$0.09	August 7, 2014	August 21, 2014
October 23, 2014	$0.09	November 6, 2014	November 20, 2014
November 11, 2014	$0.16	December 2, 2014	December 12, 2014
January 28, 2015	$0.10	February 10, 2015	February 24, 2015

The primary source for dividends paid to our shareholders is dividends paid to us from Heritage Bank. There are regulatory restrictions on the ability of our subsidiary bank to pay dividends. Under federal regulations, the dollar amount of dividends the bank may pay depends upon its capital position and recent net income. Generally, if an institution satisfies its regulatory capital requirements, it may make dividend payments up to the limits prescribed under state law and FDIC regulations. However, an institution that has converted to a stock form of ownership, as Heritage Bank has done, may not declare or pay a dividend on, or repurchase any of, its common stock if the effect thereof would cause the regulatory capital of the institution to be reduced below the amount required for the liquidation account which was established in connection with the mutual stock conversion.

As a bank holding company, our ability to pay dividends is subject to the guidelines of the Federal Reserve regarding capital adequacy and dividends. The Federal Reserve’s policy is that a bank holding company should pay cash dividends only to the extent that its net income for the past year is sufficient to cover both the cash dividends and a rate of earnings retention that is consistent with the holding company’s capital needs, asset quality and overall financial condition, and that it is inappropriate for a bank holding company experiencing serious financial problems to borrow funds to pay dividends. Under Washington law, we are prohibited from paying a dividend if, after making such dividend payment, we would be unable to pay our debts as they become due in the usual course of business, or if our total liabilities, plus the amount that would be needed, in the event we were to be dissolved at the time of the dividend payment, to satisfy preferential rights on dissolution of holders of preferred stock ranking senior in right of payment to the capital stock on which the applicable distribution is to be made exceed our total assets.

The Company has had various stock repurchase programs since March 1999. On October 23, 2014, the Company's Board of Directors authorized the repurchase of up to 5% of the Company's outstanding common shares, or approximately 1,513,000 shares, under the eleventh stock repurchase plan. The number, timing and price of shares repurchased will depend on business and market conditions, and other factors, including opportunities to deploy the Company's capital. On August 30, 2012, the Board of Directors approved the Company’s tenth stock repurchase plan, authorizing the repurchase of up to 5% of the Company’s outstanding shares of common stock, or approximately 757,000 shares. The Company will not repurchase the remaining 52,025 shares available under the tenth plan as the eleventh plan supersedes the tenth stock repurchase program. On August 30, 2011, the Board of Director approved the Company's ninth stock repurchase plan, authorizing the repurchase of up to 5% of the Company's outstanding shares of common stock, or approximately 782,000 shares over a period of twelve months.

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The following table provides total repurchased shares and average share prices under the applicable Plans and years:

	Years Ended December 31,			
	2014	2013	2012	Plan Total
Ninth Plan				
Repurchased shares	—	—	389,627	590,832
Stock repurchase average share price	$—	$—	$13.45	$12.83
Tenth Plan				
Repurchased shares	108,075	544,000	52,900	704,975
Stock repurchase average share price	$16.68	$15.88	$13.88	$15.85
Eleventh Plan				
Repurchased shares	—	—	—	—
Stock repurchase average share price	$—	$—	$—	$—

During the years ended December 31, 2014, 2013 and 2012, the Company repurchased 48,304, 13,138 and 3,419 shares at an average price of $16.53, $14.29 and $14.08 to pay withholding taxes on the vesting of restricted stock that vested during the years ended December 31, 2014, 2013 and 2012, respectively, which are not considered repurchased as part of the applicable repurchase Plans.

The following table sets forth information about the Company's purchases of its outstanding common stock during the quarter ended December 31, 2014.

Period	Total Number of Shares Purchased(1)	Average Price Paid Per Share(1)	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
October 1, 2014—October 30, 2014	277	$16.79	7,313,423	1,513,000
November 1, 2014—November 30, 2014	—	—	7,313,423	1,513,000
December 1, 2014—December 31, 2014	2,695	16.97	7,313,423	1,513,000
Total	2,972	$16.95	7,313,423	1,513,000

(1) Common shares repurchased by the Company between October 1, 2014 and December 31, 2014 included solely the cancellation of 2,972 shares of restricted stock to pay withholding taxes at an average price per share of $16.95.

The information regarding the Company's equity compensation plan is contained under "Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters" of this Form 10-K and is incorporated by reference herein.

Stock Performance Graph

The chart shown below depicts total return to stockholders during the period beginning December 31, 2009 and ending December 31, 2014. Total return includes appreciation or depreciation in market value of the Company's common stock as well as actual cash and stock dividends paid to common stockholders. Indices shown below, for comparison purposes only, are the Total Return Index for the NASDAQ Stock Market (U.S. Companies), which is a broad nationally recognized index of stock performance by publicly traded companies and the NASDAQ Bank Index, which is an index that contains securities of NASDAQ-listed companies classified according to the Industry Classification Benchmark as banks. The chart assumes that the value of the investment in Heritage's common stock and each of the three indices was $100 on December 31, 2009, and that all dividends were reinvested in Heritage

common stock.

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	Years Ended December 31,					
Index	2009	2010	2011	2012	2013	2014
Heritage Financial Corporation	$100.00	$101.02	$94.13	$116.47	$139.38	$147.38
NASDAQ Composite	100.00	118.15	117.22	138.02	193.47	222.16
NASDAQ Bank	100.00	114.16	102.17	121.26	171.86	180.31

ITEM 6. SELECTED FINANCIAL DATA

The following tables set forth certain information concerning our consolidated financial position and results of operations at and for the dates indicated and have been derived from our audited Consolidated Financial Statements. The information below is qualified in its entirety by the detailed information included elsewhere herein and should be read along with “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations” and “Item 8. Financial Statements and Supplementary Data.”

Matters affecting comparability in the five-year summary detailed below include the Cowlitz and Pierce Acquisitions in 2010, the Valley and NCB Acquisitions in 2013, and the Washington Banking Merger in 2014. See Note 2 - Business Combinations in "Item 8. Financial Statements and Supplementary Data" discussing the fiscal 2014 and 2013 mergers and acquisitions.

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	Years Ended December 31,				
	2014	2013	2012	2011	2010
	(Dollars in thousands, except per share amounts)				
Operations Data:					
Interest income	$121,106	71,428	$69,109	$74,120	$59,522
Interest expense	5,681	3,724	4,534	6,582	8,511
Net interest income	115,425	67,704	64,575	67,538	51,011
Provision for loan losses	4,594	3,672	2,016	14,430	11,990
Noninterest income	16,467	9,651	7,272	5,746	18,779
Noninterest expense	99,379	59,515	50,392	49,703	38,011
Income tax expense	6,905	4,593	6,178	2,633	6,435
Net income	21,014	9,575	13,261	6,518	13,354
Net income applicable to common shareholders	21,014	9,575	13,261	6,518	11,668
Earnings per common share					
Basic	$0.82	$0.61	$0.87	$0.42	$1.05
Diluted	0.82	0.61	0.87	0.42	1.04
Dividend payout ratio to common shareholders(1)	60.98 %	68.90 %	92.00 %	90.50 %	— %
Performance Ratios:					
Net interest spread(2)	4.45 %	4.69 %	5.03 %	5.23 %	4.56 %
Net interest margin(3)	4.53	4.80	5.17	5.41	4.78
Efficiency ratio(4)	75.35	76.94	70.14	67.82	54.46
Return on average assets	0.74	0.62	0.98	0.48	1.16
Return on average common equity	5.61	4.58	6.52	3.17	8.15

(1) Dividend payout ratio is declared dividends per common share divided by basic earnings per common share.

(2) Net interest spread is the difference between the average yield on interest earning assets and the average cost of interest bearing liabilities.

(3) Net interest margin is net interest income divided by average interest earning assets.

(4) The efficiency ratio is noninterest expense divided by the sum of net interest income and noninterest income.

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	December 31,				
	2014	2013	2012	2011	2010
	(Dollars in thousands)				
Balance Sheet Data:					
Total assets	$3,457,750	$1,659,038	$1,345,540	$1,368,985	$1,367,684
Noncovered loans receivable, net	2,102,724	1,145,509	914,366	899,086	851,006
Covered loans receivable, net	120,624	57,587	83,978	105,394	128,715
Total loans receivable, net	2,223,348	1,203,096	998,344	1,004,480	979,721
Investment securities	778,660	199,288	154,392	156,695	138,943
FDIC indemnification asset	1,116	4,382	7,100	10,350	16,071
Goodwill and other intangible assets	129,918	30,980	14,098	14,525	14,965
Deposits	2,906,331	1,399,189	1,117,971	1,136,044	1,136,276
Junior subordinated debentures	19,082	—	—	—	—
Securities sold under agreement to repurchase	32,181	29,420	16,021	23,091	19,027
Stockholders' equity	454,506	215,762	198,938	202,520	202,279
Book value per common share	$15.02	$13.31	$13.16	$13.10	$12.99
Equity to assets ratio	13.1 %	13.0 %	14.8 %	14.8 %	14.8 %
Capital Ratios:					
Total risk-based capital ratio	15.1 %	16.8 %	19.9 %	20.3 %	21.5 %
Tier 1 risk-based capital ratio	13.9	15.5	18.7	19.0	20.2
Leverage ratio	10.2	11.3	13.6	13.8	13.9
Asset Quality Ratios:					
Nonperforming noncovered loans to total noncovered loans (1)	0.35 %	0.66 %	1.41 %	2.57 %	3.03 %
Allowance for loan losses on noncovered loans to total noncovered loans (1)	1.04	1.94	2.58	2.91	2.53
Allowance for loan losses on noncovered loans to nonperforming noncovered loans (1)	294.98	292.80	183.39	113.11	83.31
Nonperforming noncovered assets to total noncovered assets (1)	0.29	0.76	1.48	2.19	2.38
Other Data:					
Number of banking offices	66	35	33	33	31
Number of full-time equivalent employees	748	373	363	354	321

(1) Nonperforming noncovered loan balances include portions guaranteed by governmental agencies of $1.6 million, $1.7 million, $1.2 million, $1.8 million and $2.3 million as of December 31, 2014, 2013, 2012, 2011 and 2010, respectively.

ITEM 7. MANGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion is intended to assist in understanding the financial condition and results of operations of the Company. The information contained in this section should be read with the December 31, 2014 audited Consolidated Financial Statements and Notes to those financial statements included in this Form 10-K.

This Form 10-K may contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements often include the words "believes," "expects," "anticipates," "estimates,"

"forecasts," "intends," "plans," "targets," "potentially," "probably," "projects," "outlook" or similar expressions or future or co
verbs such as "may," "will," "should," "would" and "could." These forward-looking statements are subject to known and unknown risks, uncertainties and other factors that could cause actual results to differ materially from the results anticipated, including:

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- our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we have acquired, including those from Cowlitz Bank, Pierce Commercial Bank, Northwest Commercial Bank, Valley Community Bancshares and Washington Banking Company, or may in the future acquire, into our operations and our ability to realize related revenue synergies and cost savings within expected time frames or at all, and any goodwill charges related thereto and costs or difficulties relating to integration matters, including but not limited to customer and employee retention, which might be greater than expected;
- the credit risks of lending activities, including changes in the level and trend of loan delinquencies and write-offs and changes in our allowance for loan losses and provision for loan losses that may be impacted by deterioration in the housing and commercial real estate markets, which may lead to increased losses and non-performing assets in our loan portfolio, and may result in our allowance for loan losses not being adequate to cover actual losses, and require us to increase our allowance for loan losses and increase our provision for loan losses;
- changes in general economic conditions, either nationally or in our market areas;
- changes in the levels of general interest rates, and the relative differences between short and long term interest rates, deposit interest rates, our net interest margin and funding sources;
- risks related to acquiring assets in or entering markets in which we have not previously operated and may not be familiar;
- fluctuations in the demand for loans, the number of unsold homes and other properties and fluctuations in real estate values in our market areas;
- results of examinations of us by the bank regulators, including the possibility that any such regulatory authority may, among other things, require us to increase our allowance for loan losses, write-down assets, change our regulatory capital position or affect our ability to borrow funds or maintain or increase deposits, which could adversely affect our liquidity and earnings;
- legislative or regulatory changes that adversely affect our business including but not limited to, the Dodd-Frank Act and implementing regulations, changes in regulatory policies and principles, or the interpretation of regulatory capital or other rules as a result of Basel III;
- our ability to control operating costs and expenses;
- increases in premiums for deposit insurance;
- the use of estimates in determining fair value of certain of our assets, which estimates may prove to be incorrect and result in significant declines in valuation;
- difficulties in reducing risk associated with the loans on our consolidated statement of financial condition;
- staffing fluctuations in response to product demand or the implementation of corporate strategies that affect our workforce and potential associated charges;
- failure or security breach of computer systems on which we depend;
- our ability to retain key members of our senior management team;
- costs and effects of litigation, including settlements and judgments;
- our ability to implement our growth strategies;
- increased competitive pressures among financial service companies;
- changes in consumer spending, borrowing and savings habits;
- the availability of resources to address changes in laws, rules, or regulations or to respond to regulatory actions;
- adverse changes in the securities markets;
- inability of key third-party providers to perform their obligations to us;
- changes in accounting policies and practices, as may be adopted by the financial institution regulatory agencies or the FASB, including additional guidance and interpretation on accounting issues and details of the implementation of new accounting methods; and
- other economic, competitive, governmental, regulatory, and technological factors affecting our operations, pricing, products and services and the other risks described elsewhere in this Form 10-K.

Some of these and other factors are discussed in this Form 10-K under the caption “Item 1A. Risk Factors” and elsewhere in this Form 10-K. Such developments could have a material adverse impact on our business, financial

position and results of operations.

Any forward-looking statements are based upon management’s beliefs and assumptions at the time they are made. We undertake no obligation to publicly update or revise any forward-looking statements included in this Form 10-K or to update the reasons why actual results could differ from those contained in such statements, whether as a

result of new information, future events or otherwise. In light of these risks, uncertainties and assumptions, you should not put undue reliance on any forward-looking statements discussed in this Form 10-K.

Critical Accounting Policies

The Company’s Consolidated Financial Statements have been prepared in accordance with accounting principles generally accepted in the United States of America. Companies may apply certain critical accounting policies requiring management to make subjective or complex judgments, often as a result of the need to estimate the effect of matters that are inherently uncertain.

The Company considers its most critical accounting estimates to be the allowance for loan losses, estimations of expected cash flows related to purchased credit impaired loans, business combinations, other than temporary impairments in the market value of investments and consideration of potential impairment of goodwill.

Allowance for Loan Losses. The allowance for loan losses is established through a provision for loan losses charged against earnings. The balance of the allowance for loan losses is maintained at the amount management believes will be appropriate to absorb known and inherent losses in the loan portfolio at the balance sheet date. The allowance for loan losses is determined by applying estimated loss factors to the credit exposure from outstanding loans.

We assess the estimated credit losses inherent in our non-classified and classified loan portfolio by considering a number of elements including:

- historical loss experience in the portfolio;
- levels of and trends in delinquencies and impaired loans;
- levels and trends in charge-offs and recoveries;
- effects of changes in risk selection and underwriting standards, and other changes in lending policies, procedures and practices;
- experience, ability, and depth of lending management and other relevant staff;
- national and local economic trends and conditions;
- external factors such as competition, legal, and regulatory; and
- effects of changes in credit concentrations.

We calculate an allowance for our loan portfolio based on an appropriate percentage loss factor that is calculated based on the above-noted elements and trends. We may record specific provisions for each impaired loan after a careful analysis of that loan’s credit and collateral factors. Our analysis of an allowance combines the provisions made for our non-impaired loans and the specific provisions made for each impaired loan.

While we believe we use the best information available to determine the allowance for loan losses, our results of operations could be significantly affected if circumstances differ substantially from the assumptions used in determining the allowance. A decline in local and national economic conditions, or other factors, could result in a material increase in the allowance for loan losses and may adversely affect the Company’s financial condition and results of operations. In addition, the determination of the amount of the allowance for loan losses is subject to review by bank regulators, as part of their routine examination process, which may result in the establishment of additional allowance for loan losses based upon their judgment of information available to them at the time of their examination.

For additional information regarding the allowance for loan losses, its relation to the provision for loan losses, risk related to asset quality and lending activity, see “—Results of Operations for the Years Ended December 31, 2014 and 2013—Provision for Loan Losses” below, “Item 1. Business—Analysis of Allowance for Loan Losses” as well as Note 7 - Allowance for Loan Losses of the Notes to Consolidated Financial Statements included in “Item 8. Financial Statements and Supplementary Data.”

Estimated Expected Cash Flows related to Purchased Credit Impaired Loans. Loans purchased with evidence of credit deterioration since origination for which it is probable that all contractually required payments will not be collected are accounted for under FASB ASC 310-30, Loans and Debt Securities Acquired with Deteriorated Credit Quality, formerly AICPA SOP 03-3 Accounting for Certain Loans or Debt Securities Acquired in a Transfer. In situations where such loans have similar risk characteristics, loans may be aggregated into pools to estimate cash flows. A pool is accounted for as a single asset with a single interest rate, cumulative loss rate and cash flow expectation.

The cash flows expected over the life of the loan or pool are estimated using an internal cash flow model that projects cash flows and calculates the carrying values of the pools, book yields, effective interest income and impairment, if any, based on pool level events. Assumptions as to default rates, loss severity and prepayment speeds are utilized to calculate the expected cash flows.
Expected cash flows at the acquisition date in excess of the fair value of loans are considered to be accretable yield, which is recognized as interest income over the life of the loan or pool using a level yield method if the timing

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and amounts of the future cash flows of the pool are reasonably estimable. Subsequent to the acquisition date, any increases in cash flow over those expected at purchase date in excess of fair value are recorded as interest income prospectively. Any subsequent decreases in cash flow over those expected at purchase date are recognized by recording an allowance for loan losses. Any disposals of loans, including sales of loans, payments in full or foreclosures result in the removal of the loan from the loan pool at the carrying amount.

Business Combinations. The Company applies the acquisition method of accounting for business combinations. Under the acquisition method, the acquiring entity in a business combination recognizes all of the identifiable assets acquired and liabilities assumed at their acquisition date fair values. Management utilizes prevailing valuation techniques appropriate for the asset or liability being measured in determining these fair values. Any excess of the purchase price over amounts allocated to assets acquired, including identifiable intangible assets, and liabilities assumed is recorded as goodwill. Where amounts allocated to assets acquired and liabilities assumed is greater than the purchase price, a bargain purchase gain is recognized. Acquisition-related costs are expensed as incurred unless they are directly attributable to the issuance of the Company's common stock in a business combination.

Other-Than-Temporary Impairments in the Market Value of Investments. Unrealized losses on investment securities available for sale and held to maturity are evaluated at least quarterly to determine whether declines in value should be considered “other than temporary” and therefore be subject to immediate loss recognition in income. Although these evaluations involve significant judgment, an unrealized loss in the fair value of a debt security is generally deemed to be temporary when the fair value of the security is below the carrying value primarily due to changes in interest rates, there has not been significant deterioration in the financial condition of the issuer, and it is not more likely than not that the Company will be required to sell the security before the anticipated recovery of its remaining carrying value. An unrealized loss in the value of an equity security is generally considered temporary when the fair value of the security is below the carrying value primarily due to current market conditions and not deterioration in the financial condition of the issuer and it is not more likely than not that the Company will be required to sell the security before the anticipated recovery of its remaining carrying value. Other factors that may be considered in determining whether a decline in the value of either a debt or an equity security is “other than temporary” include ratings by recognized rating agencies; actions of commercial banks or other lenders relative to the continued extension of credit facilities to the issuer of the security; the financial condition, capital strength and near-term prospects of the issuer and recommendations of investment advisors or market analysts. Therefore, continued deterioration of market conditions could result in additional impairment losses recognized within the investment portfolio.

Goodwill. Goodwill represents the excess of the purchase price over the net assets acquired in the of merger of Washington Banking Company and the acquisitions of Valley Community Bancshares, Western Washington Bancorp and North Pacific Bank. The Company’s goodwill is assigned to Heritage Bank and is evaluated for impairment at the Heritage Bank level (reporting unit). Goodwill is not amortized, but is reviewed for impairment annually and between annual tests if an event occurs or circumstances change that might indicate the Company’s recorded value is more than its implied value. Such indicators may include, among others: a significant adverse change in legal factors or in the general business climate; significant decline in the Company’s stock price and market capitalization; unanticipated competition; and an adverse action or assessment by a regulator. Any adverse changes in these factors could have a significant impact on the recoverability of goodwill and could have a material impact on the Company’s Consolidated Financial Statements.

When required, the goodwill impairment test involves a two-step process. The first test for goodwill impairment is done by comparing the reporting unit’s aggregate fair value to its carrying value. Absent other indicators of impairment, if the aggregate fair value exceeds the carrying value, goodwill is not considered impaired and no additional analysis is necessary. If the carrying value of the reporting unit were to exceed the aggregate fair value, a second test would be performed to measure the amount of impairment loss, if any. To measure any impairment loss the implied fair value would be determined in the same manner as if the reporting unit were being acquired in a business combination. If the implied fair value of goodwill is less than the recorded goodwill an impairment charge would be recorded for the difference.

During 2011, ASU 2011-08 Intangibles—Goodwill and Other (Topic 350) was issued. Under the ASU, an entity is not required to calculate the fair value of a reporting unit unless the entity determines that it is more likely than not that its fair value is less than its carrying amount. In other words, before the first step of the existing guidance, the entity has the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that the fair value of goodwill is less than carrying value. The qualitative assessment includes adverse events or circumstances identified that could negatively affect the reporting units' fair value as well as positive and mitigating events. If, after assessing the totality of events or circumstances, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step process is unnecessary. While the Company adopted the ASU in 2011, for the year ended December 31, 2014, the

Company completed step one of the two-step process and concluded that the reporting unit's fair value was greater than its carrying value and there was no impairment of goodwill.

Our Strategy

Our primary objective is to be a well-capitalized, profitable community banking organization, with balanced growth while emphasizing lending and deposit relationships with small and medium size businesses along with their owners and the general public. We consider ourselves to be an innovative team providing financial services focusing on the success of our customers. Our stated mission is: "We are committed to being the leading community bank in the Pacific Northwest by continuously improving: Customer Satisfaction, Employee Empowerment, Community Investment and Shareholder Value." We will seek to achieve our objective through the following strategies:

Expand geographically as opportunities present themselves. We are committed to continuing the controlled expansion of our franchise through strategic acquisitions designed to increase our market share and enhance franchise value. We believe that consolidation across the community bank landscape will continue to take place and further believe that, with our capital and liquidity positions, our approach to credit management and extensive acquisition experience, we are well positioned to take advantage of acquisitions or other business opportunities in our market areas. In markets where we wish to enter or expand our business, we will also consider opening de novo branches. In the past, we have successfully integrated acquired institutions and opened de novo branches. We will continue to be disciplined and opportunistic as it pertains to future acquisitions and de novo branching focusing on the Pacific Northwest markets we know and understand.

Focus on Asset Quality. A strong credit culture is a high priority for us. We have a well-developed credit approval structure that has enabled us to maintain a standard of asset quality that we believe is conservative while at the same time maintaining our lending objectives. We will continue to focus on loan types and markets that we know well and where we have a historical record of success. We focus on loan relationships that are well diversified in both size and industry types. With respect to commercial business lending, which is our predominant lending activity, we view ourselves as cash-flow lenders obtaining additional support from realistic collateral values, personal guarantees and secondary sources of repayment. We have a problem loan resolution process that is focused on quick detection and feasible solutions. We seek to maintain strong internal controls and subject our loans to periodic internal loan reviews.

Maintain Strong Balance Sheet. In addition to our focus on underwriting, we believe that the strength of our balance sheet has allowed us to endure the economic downturn experienced by the Pacific Northwest more successfully than many of our competitors. As of December 31, 2014, the ratio of our allowance for loan losses on noncovered loans to total noncovered loans was 1.04% and the ratio of the allowance for loan losses on noncovered loans to nonperforming noncovered loans was 294.98%. Our liquidity position is also strong, with $121.6 million in cash and cash equivalents as of December 31, 2014. As of December 31, 2014, the regulatory capital ratios of our subsidiary bank was well in excess of the levels required for "well-capitalized" status, and our consolidated total risk-based capital, Tier 1 risk-based capital and leverage capital ratios were 15.1%, 13.9% and 10.2%, respectively.

Deposit Growth. Our strategic focus is to continuously grow deposits with emphasis on total relationship banking with our business and retail customers. We continue to seek to increase our market share in the communities we serve by providing exceptional customer service, focusing on relationship development with local businesses and strategic branch expansion. Our primary focus is to maintain a high level of non-maturity deposits to internally fund our loan growth with a low reliance on maturity (certificate) deposits. At December 31, 2014, as a percentage of our total deposits, non-maturity deposits were 81.9%. We maintain state-of-the-art technology-based products, including on-line personal financial management, business cash management, and business remote deposit products that enable us to compete effectively with banks of all sizes. Our retail management team is well-seasoned and has strong ties to the communities we serve with a strong focus on relationship building and customer service.

Emphasize business relationships with a focus on commercial lending. We will continue to provide primarily commercial business, commercial real estate and residential construction loans with an emphasis on owner occupied commercial real estate and commercial business lending, and the deposit balances that accompany these relationships. Our seasoned lending staff has extensive knowledge and can add value through a focused advisory role that we believe strengthens our customer relationships and develops loyalty. We currently have and will seek to maintain a

diversified portfolio of lending relationships without concentrations in any industry.

Recruit and retain highly competent personnel to execute our strategies. Our compensation and staff development programs are aligned with our strategies to grow our loans and core deposits while maintaining our focus on asset quality. Our incentive systems are designed to achieve balanced high quality asset growth while maintaining appropriate mechanisms to reduce or eliminate incentive payments when appropriate. Our equity compensation programs and retirement benefits are designed to build and encourage employee ownership at all levels of the Company

and we align employee performance objectives with corporate growth strategies and shareholder value. We have a strong corporate culture, which is supported by our commitment to internal development and promotion from within as well as the retention of management and officers in key roles.

Financial Overview

Heritage Financial Corporation is a bank holding company which primarily engages in the business activities of our wholly owned subsidiary, Heritage Bank. We provide financial services to our local communities with an ongoing strategic focus on our commercial banking relationships, market expansion and asset quality.

The Company has focused on expanding business over the past five years. In 2010, the Company completed two FDIC-assisted transactions of Cowlitz Bank in July 2010 and Pierce Commercial Bank in November 2010. In 2013, the Company completed two open-bank acquisitions of Northwest Commercial Bank in January 2013 and Valley Community Bancshares in July 2013. In May 2014, the Company completed the merger with Washington Banking Company. These acquisitions and mergers, together with organic growth of the business, has significantly increased the Company's net assets.

During the period from December 31, 2010 through December 31, 2014 our total assets have increased $2.09 billion, or 152.8%, to $3.46 billion as of December 31, 2014 from $1.37 billion at December 31, 2010. The noncovered loans receivable, net of allowance for loan losses grew $1.25 billion, or 147.1%, to $2.10 billion as of December 31, 2014 from $851.0 million at December 31, 2010. Our emphasis in growing our commercial business loan portfolio, in addition to mergers and acquisitions, resulted in an increase in noncovered commercial business loans of $993.6 million, or 139.9%, since December 31, 2010. Loan increases have benefited from the merger of Washington Banking and the acquisitions of Valley, Northwest Commercial Bank, Pierce Commercial Bank and Cowlitz Bank and our emphasis on increasing our lending in our market areas.

Deposits increased $1.77 billion, or 155.8%, to $2.91 billion at December 31, 2014 from $1.14 billion at December 31, 2010. From December 31, 2010 to December 31, 2014, non-maturity deposits (total deposits less certificate of deposit accounts) increased $1.65 billion, or 224.7% to $2.38 billion at December 31, 2014. As a result, the percentage of certificate of deposit accounts to total deposits decreased to 18.1% at December 31, 2014 from 35.5% at December 31, 2010.

Stockholders’ equity has increased by $252.2 million to $454.5 million at December 31, 2014 from $202.3 million at December 31, 2010 due primarily to a combination of earnings and issuances of common stock, partially offset by the redemption of preferred stock, repurchases of common stock and declaration of cash dividends. Our annual net income increased by 57.4%, or $7.7 million, to $21.0 million for the year ended December 31, 2014 from $13.4 million for the year ended December 31, 2010 due primarily to an increase of $64.4 million in net interest income that exceeded an increase in noninterest expense of $61.4 million, and a decrease in the provision for loan losses of $7.4 million.

Our core profitability depends primarily on our net interest income, which is the difference between the income we receive on our loan and investment portfolios, and our cost of funds, which consists of interest paid on deposits and borrowed funds. Like most financial institutions, our interest income and cost of funds are affected significantly by general economic conditions, particularly changes in market interest rates and government policies.

Changes in net interest income result from changes in volume, net interest spread, and net interest margin. Volume refers to the average dollar amounts of interest earning assets and interest bearing liabilities. Net interest spread refers to the difference between the average yield on interest earning assets and the average cost of interest bearing liabilities. Net interest margin refers to net interest income divided by average interest earning assets and is influenced by the level and relative mix of interest earning assets and interest bearing and noninterest bearing liabilities.

The following table provides relevant net interest income information for selected periods. The average daily loan balances presented in the table are net of allowances for loan losses. Nonaccrual loans have been included in the tables as loans carrying a zero yield. Yields on tax-exempt securities and loans have not been presented on a tax-equivalent basis.

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	Years Ended December 31,											
	2014				2013				2012			
	Average Balance	Interest Earned/ Paid	Average Yield/ Rate		Average Balance	Interest Earned/ Paid	Average Yield/ Rate		Average Balance	Interest Earned/ Paid	Average Yield/ Rate	
	(Dollars in thousands)											
Interest Earning Assets:												
Loans, net	$1,871,696	$110,437	5.90	%	$1,124,828	$67,630	6.01	%	$996,186	$65,588	6.58	%
Taxable securities	383,626	7,328	1.91		117,132	1,918	1.64		118,124	2,195	1.86	
Nontaxable securities	145,113	2,886	1.99		64,018	1,539	2.40		42,272	1,097	2.60	
Other interest earning assets	150,189	455	0.30		104,770	341	0.33		92,324	229	0.25	
Total interest earning assets	2,550,624	121,106	4.75		1,410,748	71,428	5.06		1,248,906	69,109	5.53	
Noninterest earning assets	295,666				129,324				105,166			
Total assets	$2,846,290				$1,540,072				$1,354,072			
Interest Bearing Liabilities:												
Certificates of deposit	$494,948	$2,991	0.60	%	$307,464	$2,478	0.81	%	$306,772	$3,016	0.98	%
Savings accounts	282,150	252	0.09		143,412	164	0.11		113,119	204	0.18	
Interest bearing demand and money market accounts	1,049,078	1,907	0.18		541,793	1,031	0.19		466,268	1,249	0.27	
Total interest bearing deposits	1,826,176	5,150	0.28		992,669	3,673	0.37		886,159	4,469	0.50	
Junior subordinated debentures	12,751	458	3.59		—	—	—		—	—	—	
FHLB advances and other borrowings	111	—	—		—	—	—		—	—	—	
Securities sold under agreement to repurchase	27,984	73	0.26		19,102	51	0.27		18,314	65	0.35	
	1,867,022	5,681	0.30		1,011,771	3,724	0.37		904,473	4,534	0.50	

Total interest
bearing
liabilities

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	Years Ended December 31,								
	2014			2013			2012		
	Average Balance	Interest Earned/ Paid	Average Yield/ Rate	Average Balance	Interest Earned/ Paid	Average Yield/ Rate	Average Balance	Interest Earned/ Paid	Average Yield/ Rate
	(Dollars in thousands)								
Demand and other noninterest bearing deposits	574,692			308,582			237,888		
Other noninterest bearing liabilities	29,669			10,543			8,310		
Stockholders' equity	374,907			209,176			203,401		
Total liabilities and stock-holders' equity	$2,846,290			$1,540,072			$1,354,072		
Net interest income		$115,425			$67,704			$64,575	
Net interest spread			4.45 %			4.69 %			5.03 %
Net interest margin			4.53 %			4.80 %			5.17 %
Average interest earning assets to average interest bearing liabilities			136.61 %			139.43 %			138.08 %

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The following table provides the amount of change in our net interest income attributable to changes in volume and changes in interest rates. Changes attributable to the combined effect of volume and interest rates have been allocated proportionately for changes due specifically to volume and interest rates.

	Years Ended December 31,					
	2014 Compared to 2013			2013 Compared to 2012		
	Increase (Decrease) Due to			Increase (Decrease) Due to		
	Volume	Rate	Total	Volume	Rate	Total
	(In thousands)					
Interest Earning Assets:						
Loans	$44,068	$(1,261)	$42,807	$7,735	$(5,693)	$2,042
Taxable securities	5,090	320	5,410	(16)	(261)	(277)
Nontaxable securities	1,613	(266)	1,347	523	(81)	442
Other interest earning assets	138	(24)	114	40	72	112
Interest income	$50,909	$(1,231)	$49,678	$8,282	$(5,963)	$2,319
Interest Bearing Liabilities:						
Certificates of deposit	$1,133	$(620)	$513	$5	$(543)	$(538)
Savings accounts	124	(36)	88	35	(75)	(40)
Interest bearing demand and money market accounts	922	(46)	876	144	(362)	(218)
Total interest bearing deposits	2,179	(702)	1,477	184	(980)	(796)
Junior subordinated debentures	458	—	458	—	—	—
FHLB advances and other borrowings	—	—	—	—	—	—
Securities sold under agreement to repurchase	23	(1)	22	2	(16)	(14)
Interest expense	$2,660	$(703)	$1,957	$186	$(996)	$(810)
Net Interest Income	$48,249	$(528)	$47,721	$8,096	$(4,967)	$3,129

Results of Operations for the Years Ended December 31, 2014 and 2013

Earnings Summary. Net income applicable to common shareholders of $0.82 per diluted common share was recorded for the year ended December 31, 2014 compared to $0.61 per diluted common share for the year ended December 31, 2013. Net income for the year ended December 31, 2014 was $21.0 million compared to net income of $9.6 million for the same period in 2013. The $11.4 million increase was primarily the result of a $49.7 million increase in interest income and a $6.8 million increase in noninterest income, partially offset by a $39.9 million increase in noninterest expense, a $2.3 million increase in income tax expense, a $2.0 million increase in interest expense and a $922,000 increase in the provision for loan losses. The Company’s efficiency ratio decreased to 75.3% for the year ended December 31, 2014 from 76.9% for the year ended December 31, 2013 primarily due to net interest income increases related to the mergers and acquisitions as well as operating efficiencies gained by the Company which did not increase noninterest expenses by the same extent.

Net Interest Income. Net interest income increased $47.7 million, or 70.5%, to $115.4 million for the year ended December 31, 2014 compared to $67.7 million for the previous year. The increase in net interest income was due primarily to increases in average interest earning assets, substantially attributable to the Washington Banking Merger, and the results of the positive effects of the discount accretion on the acquired loan portfolios for the year ended December 31, 2014. The increase in net interest income was partially offset by the decrease in the net interest margins due primarily to lower contractual loan note rates in the current lending environment. Net interest income as a percentage of average interest earning assets (net interest margin) for the year ended December 31, 2014 decreased 27 basis points to 4.53% from 4.80% for the previous year. Our net interest spread for the year ended December 31, 2014 decreased 24 basis points to 4.45% from 4.69% for the prior year.

Total interest income increased $49.7 million, or 69.5%, to $121.1 million for the year ended December 31, 2014, from $71.4 million for the year ended December 31, 2013. The increase in interest income was due primarily to the effects of the Washington Banking Merger and the positive effects of the accretable discount, offset partially by

lower yields on interest earning assets. During the year ended December 31, 2014, the Company recorded approximately $10.8 million of discount accretion into interest income that related to the Washington Banking Merger. This income would be in addition to the acquired loans' contractual interest income. The balance of average interest earning assets (including nonaccrual loans) increased $1.14 billion, or 80.8%, to $2.55 billion for the year ended December 31, 2014 from $1.41 billion for the year ended December 31, 2013. The majority of this increase in interest earning assets was a result of the Washington Banking Merger. The Company acquired fair value at the May 1, 2014 merger date of $458.3 million in investment securities, $896.0 million in noncovered loans, $107.1 million in covered loans and $7.1 million of FHLB stock.

The yield on interest earning assets decreased 31 basis points to 4.75% for the year ended December 31, 2014 from 5.06% for the year ended December 31, 2013. The decrease in the yield on interest earning assets for the year ended December 31, 2014 reflects the decreased loan yields due primarily to lower contractual note rates, offset partially by the effects of the overall discount accretion on all the acquired loan portfolios. The effect of discount accretion on net interest margin for the year ended December 31, 2014 and December 31, 2013 is as follows:

	Years Ended December 31,			
	2014		2013	
Net interest margin, excluding incremental accretion on purchased loans (1)	3.97	%	4.32	%
Impact on net interest margin from incremental accretion on purchased loans (1)	0.56		0.48	
Net interest margin	4.53	%	4.80	%

(1) The incremental accretion income represents the amount of income recorded on the purchased loans in excess of the contractual stated interest rate in the individual loan notes. This income results from the discount established at the time these loan portfolios were acquired and modified quarterly as a result of cash flow re-estimation.

The yield on interest earning assets was reduced by nonaccruing loans. For both the years ended December 31, 2014 and December 31, 2013, nonaccruing loans reduced the yield on interest earning assets by approximately five basis points. Nonaccrual noncovered loans totaled $7.5 million at December 31, 2014 compared to $7.7 million at December 31, 2013.

Interest income on taxable and nontaxable investment securities increased $6.8 million to $10.2 million for the year ended December 31, 2014 from $3.5 million for the year ended December 31, 2013 due primarily to an increase in the average investment securities as a result of the Washington Banking Merger and an increase in yields on taxable investments securities, offset by lower yields earned on the nontaxable investment securities in 2014 as a result of declining interest rates. The changes in average balances and interest income on other interest earning had minimal impact on net interest margins for the years ended December 31, 2014 and 2013.

Total interest expense increased by $2.0 million, or 52.6%, to $5.7 million for the year ended December 31, 2014 from $3.7 million for the year ended December 31, 2013. The increase in interest expense was due to an increase in the average deposit balance, primarily as a result of the deposits acquired in the Washington Banking Merger which had a fair value at the acquisition date of $1.43 billion. The effects of the increase in the average deposit balance was offset by lower rates paid on interest bearing deposits, reflecting the relatively low interest rate environment. The average rate paid on interest bearing deposits decreased to 0.28% for the year ended December 31, 2014 from 0.37% for the year ended December 31, 2013. The Company also acquired junior subordinated debentures in the Washington Banking Merger with a fair value of $18.9 million at the merger date. The average rate paid on these liabilities during 2014 was 3.59%. Total average interest bearing liabilities increased by $855.3 million, or 84.5%, to $1.87 billion for the year ended December 31, 2014 from $1.01 billion for the year ended December 31, 2013 and the average rate was 0.30% and 0.37%, respectively.

Provision for Loan Losses. The provision for loan losses increased $922,000, or 25.1%, to $4.6 million for the year ended December 31, 2014 from $3.7 million for the year ended December 31, 2013. The Bank has established a comprehensive methodology for determining the allowance for loan losses and related provision for loan losses on loans. On a quarterly basis, the Bank performs an analysis taking into consideration pertinent factors underlying the quality of the loan portfolio. These factors include changes in the amount and composition of the loan portfolio, historical loss experience for various loan classes, changes in economic conditions, delinquency rates, a detailed

analysis of individual loans on nonaccrual status, and other factors to determine the level of the allowance for loan losses and the related provision for loan losses.

The provision for loan losses on noncovered loans increased $448,000, or 25.1%, to $2.2 million for the year ended December 31, 2014 from $1.8 million for the year ended December 31, 2013. The increase in provision expense

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on noncovered loans was due primarily to the resolution of nonperforming loans and the increase in volume of loans, offset partially by an improvement in the economy and a decrease in net charge-offs during the year ended December 31, 2014 compared the prior year.

The Bank had net charge-offs on noncovered loans of $2.7 million for the year ended December 31, 2014 compared to $3.4 million for the year ended December 31, 2013. The ratio of net charge-offs of noncovered to average total noncovered loans outstanding was 0.15% for the year ended December 31, 2014 and 0.32% for the year ended December 31, 2013. Total gross balance of noncovered loans at December 31, 2014 and 2013 were $2.13 billion and $1.17 billion, respectively. The general allowance as a percentage of non-impaired noncovered loans was 0.90% and 1.63% at December 31, 2014 and 2013, respectively. The decrease in the percentage during the noted periods is due to reduction in the historical loss factors, change in the mix of loans, and a general improvement in the credit environment. The general allowance as a percentage of non-impaired noncovered loans also decreased during the year ended December 31, 2014 as a result of the Washington Banking Merger, since the acquired loans were recorded at a net discount at the merger date and, accordingly, no allowance for loan losses was initially recorded for the acquired loans. The remaining discount for these acquired loans at December 31, 2014 was deemed sufficient to absorb known and inherent losses in the loan portfolio thereby reducing the need for an additional general valuation allowance.

The following table outlines the allowance for loan losses and related outstanding loan balances on noncovered loans at December 31, 2014 and 2013:

	December 31, 2014		December 31, 2013	
	(Dollars in thousands)			
General Valuation Allowance:				
Allowance for loan losses on noncovered loans	$18,918		$18,618	
Gross noncovered loan balance of non-impaired loans	2,099,658		1,140,967	
Percentage	0.90	%	1.63	%
Specific Valuation Allowance:				
Allowance for loan losses on noncovered loans	$3,235		$4,039	
Gross noncovered loan balance of impaired loans	26,156		29,869	
Percentage	12.37	%	13.52	%
Total Allowance for Loan Losses on noncovered loans:				
Allowance for loan losses on noncovered loans	$22,153		$22,657	
Gross noncovered loan balance	2,125,814		1,170,836	
Percentage	1.04	%	1.94	%

The allowance for loan losses on noncovered loans decreased by $504,000, or 2.2%, to $22.2 million at December 31, 2014 from $22.7 million at December 31, 2013. As of December 31, 2014, the Bank identified $7.5 million of nonperforming noncovered loans and $18.8 million of performing restructured noncovered loans for a total of $26.2 million of impaired noncovered loans. Of these impaired loans, $6.3 million have no allowances for loan losses as their estimated collateral value or expected cash flow is equal to or exceeds their carrying costs. The remaining $19.9 million have related allowances for loan losses totaling $3.2 million. Based on the comprehensive methodology, management deemed the allowance for loan losses on noncovered loans of $22.2 million at December 31, 2014 (1.04% of total noncovered loans and 294.98% of nonperforming noncovered loans) appropriate to provide for probable incurred losses based on an evaluation of known and inherent risks in the loan portfolio at that date.

The provision for loan losses on covered loans increased $474,000, or 25.1%, to $2.4 million for the year ended December 31, 2014 compared to $1.9 million for the year ended December 31, 2013. The increase in provision for loan losses on covered loans recorded for the year ended December 31, 2014 was primarily a result of loans acquired in the Washington Banking Merger which had $646,000 of provision expense recorded during the year. The provision expense was necessary based on loan events that occurred after the May 1, 2014 merger date which caused the estimated loss on the loan to increase from original expectations. There was also the default of two large borrowers

from the Cowlitz Acquisition which caused $915,000 in provision expense during the year ended December 31, 2014. The impact of these events was partially offset by the general improvements in the remaining loans' expected cash flows. The gross balance of the covered loans increased to $126.2 million at December 31, 2014 from $63.8 million at December 31, 2013 as a result of the covered loans acquired in the Washington Banking Merger. The Bank recorded

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net charge-offs on covered loans of $3.0 million for the year ended December 31, 2014 as compared to $73,000 for the year ended December 31, 2013.

The allowance for loan losses on covered loans decreased $591,000, or 9.58% to $5.6 million at December 31, 2014 from $6.2 million at December 31, 2013. The decrease was primarily the result of the resolution of specific covered loans, offset by the general improvements in the expected cash flow of the covered loans.

While the Bank believes it has established its existing allowance for loan losses in accordance with GAAP, there can be no assurance that regulators, in reviewing the Bank's loan portfolios, will not request the Bank to increase significantly its allowance for loan losses. In addition, because future events affecting borrowers and collateral cannot be predicted with certainty, there can be no assurance that the existing allowance for loan losses is appropriate or that increased provisions will not be necessary should the quality of the loans deteriorate. Any material increase in the allowance for loan losses would adversely affect the Company’s financial condition and results of operations. For additional information, see “Item 1. Business—Analysis of Allowance for Loan Losses.”

Noninterest Income. Total noninterest income increased $6.8 million, or 70.6%, to $16.5 million for the year ended December 31, 2014 compared to $9.7 million for the prior year. The components of the noninterest income and the changes from prior year are as follows:

	Years Ended December 31,			
	2014	2013	Change 2014 vs. 2013	Percentage Change
	(Dollars in thousands)			
Bargain purchase gain on bank acquisition	$—	$399	$(399)	100.0 %
Service charges and other fees	11,143	5,936	5,207	87.7
Merchant Visa income, net	1,076	862	214	24.8
Change in FDIC indemnification asset	(2,543)	(181)	(2,362)	(1,305.0)
Gain on sale of investment securities, net	287	—	287	100.0
Gain on sale of loans, net	1,518	142	1,376	969.0
Other income	4,986	2,493	2,493	100.0
Total noninterest income	$16,467	$9,651	$6,816	70.6 %

The change in FDIC indemnification asset includes amortization of the FDIC indemnification asset and increases/decreases to the FDIC indemnification asset as a result of changes in projected remaining cash flows of the covered loans. The $2.4 million decrease was primarily due to a $2.2 million decrease in the loan (recapture) impairment and a $204,000 increase in amortization expense to $1.5 million for the year ended December 31, 2014 compared to $1.3 million for the year ended December 31, 2013. The Company recorded loan recaptures during the fourth quarter of 2014 due to the revised estimated loss projections given the 2015 expiration date of certain shared-loss agreements. While the Bank believes additional losses may be incurred on the assets, the timing of those losses will not likely occur before the expiration dates. The increase in the amortization expense was primarily due to the overall improvements of the covered loans because less loss is anticipated than prior period estimates. The balance of the indemnification asset at December 31, 2014 was $1.1 million compared to $4.4 million at December 31, 2013.

Service charges and other fees increased $5.2 million, or 87.7%, to $11.1 million for the year ended December 31, 2014 from $5.9 million for the year ended December 31, 2013 primarily as a result of an increase in the deposit accounts acquired in the Washington Banking Merger. See "Item 1. Business - Deposit Activities and Other Sources of Funds" for additional information. Total deposits increased $1.51 billion, or 107.7% to $2.91 billion at December 31, 2014 from $1.40 billion at December 31, 2013.

Gain on sale of loans, net increased $1.4 million, or 969.0%, to $1.5 million for the year ended December 31, 2014 from $142,000 for the year ended December 31, 2013 as a result of the Bank resuming mortgage banking operations. The Bank had ceased mortgage banking operations in the second quarter of 2013 and resumed these operations on the May 1, 2014 effective date of the merger as Washington Banking had a strong operational presence in the mortgage banking operations.

Other income increased $2.5 million, or 100.0%, to $5.0 million for the year ended December 31, 2014 from $2.5 million for the year ended December 31, 2013 partially due to recoveries on legacy Washington Banking loans which were fully charged-off prior to the merger date. The Bank had estimated that there would be no such recoveries for fair value purposes, but the recovery efforts of the credit department has exceeded anticipated results. Other

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income also increased by $390,000 in 2014 as a result of earnings on the BOLI from the $32.5 million of BOLI acquired on May 1, 2014 in the Washington Banking Merger. The increase in other income for 2014 was partially offset by a gain on sale of a bank branch of $596,000 recorded during the year ended December 31, 2013.
The bargain purchase gain on bank acquisition of $399,000 for the year ended December 31, 2013 was the result of the NCB Acquisition in January 2013. See Note - 2 Business Combinations of the Notes to Consolidated Financial Statements in "Item 8. Financial Statements and Supplementary Data" for additional information on the NCB Acquisition.
Noninterest Expense.   Noninterest expense increased $39.9 million or 67.0% to $99.4 million for the year ended December 31, 2014 compared to $59.5 million for the year ended December 31, 2013.
The following table presents the key components of noninterest expense and the changes from prior year:

	Years Ended December 31,				
	2014	2013	Change 2014 vs. 2013	Percentage Change	
	(Dollars in thousands)				
Compensation and employee benefits	$52,634	$31,612	$21,022	66.5	%
Occupancy and equipment	13,406	9,724	3,682	37.9	
Data processing	9,243	4,806	4,437	92.3	
Marketing	2,502	1,598	904	56.6	
Professional services	6,185	3,936	2,249	57.1	
State and local taxes	1,976	1,150	826	71.8	
Impairment loss on investment securities, net	45	38	7	18.4	
Federal deposit insurance premium	1,718	1,001	717	71.6	
Other real estate owned, net	638	309	329	106.5	
Amortization of intangible assets	1,920	543	1,377	253.6	
Other expense	9,112	4,798	4,314	89.9	
Total noninterest expense	$99,379	$59,515	$39,864	67.0	%

The increase in total noninterest expense for the year ended December 31, 2014 was due primarily to the Washington Banking Merger and additional ongoing operating costs from mergers and acquisitions as well as specific costs identified in the Company Initiatives table below. These initiatives include the NCB and Valley Acquisitions, the merger of Central Valley Bank and the merger of Washington Banking Company, all of which are discussed in Notes 1 and 2 of the Notes to Consolidated Financial Statements in "Item. 8 Financial Statements and Supplementary Data". Additionally, a core system conversion occurred in fourth quarter of 2013 whereby, after 18 years of using FiServ's Total Plus core system, the Company converted to FiServ's DNA platform which provides a variety of efficiencies in all operation areas of the Bank. The consolidation of existing branches also occurred in the fourth quarter of 2013 with the Company consolidating three Heritage branch locations to nearby branches. The table below includes each of the Company's major initiatives as well as the direct costs associated with the initiatives for the years ended December 31, 2014 and 2013. The amounts include identifiable costs paid to third party providers as well as any retention bonuses or severance payment made in conjunction with these initiatives. The amounts do not include costs of additional staffing required to be maintained or utilized during a period of time in order to complete the initiatives.

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	Years Ended December 31,	
	2014	2013
	(In thousands)	
Company Initiatives:		
NCB Acquisition	$—	$794
CVB Merger	—	220
Valley Acquisition	443	2,118
Core system conversion	40	842
Consolidation of existing branches	11	238
Washington Banking Merger	9,094	890
Total expense	$9,588	$5,102

The following table further segregates the Company initiative costs by financial statement caption.

	Years Ended December 31,	
	2014	2013
	(In thousands)	
Expense Caption:		
Compensation and employee benefits	$1,522	$475
Occupancy and equipment	602	1,328
Data processing	3,038	1,291
Marketing	140	34
Professional services	3,751	1,876
Other expense	535	98
Total expense	$9,588	$5,102

The types of expenses associated with the significant expense categories in the table above are summarized as follows:

- Compensation and employee benefits expense consisted substantially of retention bonus and severances packages paid to transition employees.
- Occupancy and equipment expense consisted primarily of lease termination costs.
- Data processing expense consisted of costs relating to the Company's core system conversion as well as data conversions of the NCB, Valley Bank and Whidbey Island Bank information to the Heritage core system.
- Professional services expense related to fees paid to: (1) financial advisors for the NCB Acquisition, Valley Acquisition and Washington Banking Merger, (2) attorney, accountant and consultant fees related to mergers and acquisitions, and (3) consultant fees relating to the Company's core system conversion.

Other expense increased $4.3 million, or 89.9%, to $9.1 million for the year ended December 31, 2014 from $4.8 million for the year ended December 31, 2013. Other expense includes, but is not limited to, items such as courier services, phone costs, travel expenses, investor relations, and certain employee-related costs such as travel and meals. The increases in other expense are primarily as a result of the Washington Banking Merger and the general increase due to the growth of the Company during the year ended December 31, 2014 which is demonstrated by the increase in total assets to $3.46 billion at December 31, 2014 from $1.66 billion at December 31, 2013.

The efficiency ratio for the year ended December 31, 2014 was 75.3% compared to 76.9% for the same period in the prior year. The efficiency ratio consists of noninterest expense divided by the sum of net interest income before provision for loan losses plus noninterest income. The decrease in the ratio for the year ended December 31, 2014 was primarily related to the increase in net interest income related to mergers and acquisitions as described above which outpaced the increase in the noninterest expense as described above. As cost savings are realized from the Washington Banking Merger, the Company expects the efficiency ratio to continue to decrease.

Income Tax Expense. The provision for income taxes increased by $2.3 million to an expense of $6.9 million for the year ended December 31, 2014 from an expense of $4.6 million for the year ended December 31, 2013. The Company's effective income tax rate was 24.7% for the year ended December 31, 2014 compared to 32.4% for the

same period in 2013. The decrease in the Company's effective income tax rate from the prior year was primarily due to higher levels of tax-exempt income in 2014, $812,000 in federal tax credits from new market tax credit partnerships and a $728,000 income tax benefit related to the resolution of a tax position previously taken by Washington Banking Company.

Results of Operations for the Years Ended December 31, 2013 and 2012

Earnings Summary. Net income applicable to common shareholders of $0.61 per diluted common share was recorded for the year ended December 31, 2013 compared to $0.87 per diluted common share for the year ended December 31, 2012. Net income for the year ended December 31, 2013 was $9.6 million compared to net income of $13.3 million for the same period in 2012. The $3.7 million decrease was primarily the result of a $9.1 million increase in noninterest expense and a $1.7 million increase in the provision for loan losses, partially offset by a $2.3 million increase in interest income, a $2.4 million increase in noninterest income, a $1.6 million decrease in income tax expense and a $810,000 decrease in interest expense. The Company's efficiency ratio increased to 76.9% for the year ended December 31, 2013 from 70.1% for the year ended December 31, 2012 primarily due to increases in the noninterest expense of $4.5 million related to the Company initiatives including the acquisitions and system conversions of Northwest Commercial Bank and Valley Bank, the merger of Central Valley Bank, the core system conversion, the consolidation of existing branches and the Washington Banking Company merger. The details of these expenses are included in the "Noninterest Expense" section below.

Net Interest Income. Net interest income increased $3.1 million, or 4.8%, to $67.7 million for the year ended December 31, 2013 compared to $64.6 million for the previous year. The increase in net interest income was due primarily to increases in average interest earning assets, substantially attributable to the NCB and Valley Acquisitions, and the results of the positive effects of the discount accretion on the acquired loan portfolios for the year ended December 31, 2013. The increase in net interest income was partially offset by the decrease in the net interest margins due primarily to lower contractual loan note rates in the current lending environment. Net interest income as a percentage of average interest earning assets (net interest margin) for the year ended December 31, 2013 decreased 37 basis points to 4.80% from 5.17% for the previous year. Our net interest spread for the year ended December 31, 2013 decreased to 4.69% from 5.03% for the prior year.

Total interest income increased $2.3 million, or 3.4%, to $71.4 million for the year ended December 31, 2013, from $69.1 million for the year ended December 31, 2012. The increase in interest income was due primarily to the effects of the NCB and Valley Acquisitions and the positive effects of the accretable discount, offset partially by lower yields on interest earning assets. During the year ended December 31, 2013, the Company recorded approximately $2.7 million of discount accretion into interest income that related to the NCB and Valley Acquisitions. This income would be in addition to the acquired loans' contractual interest income. The balance of average interest earning assets (including nonaccrual loans) increased $161.8 million, or 13.0%, to $1.41 billion for the year ended December 31, 2013 from $1.25 billion for the year ended December 31, 2012. The majority of this increase in interest earning assets was a result of the NCB and Valley Acquisitions. The Company acquired combined fair value at respective acquisition dates of $14.9 million in interest earning deposits, $57.1 million in investment securities and $168.6 million in noncovered loans. The Company additionally generated organic growth by increasing the noncovered loan receivable balance by $61.0 million, or 6.5% due to loan originations, net of loan payments.

The yield on interest earning assets decreased 47 basis points to 5.06% for the year ended December 31, 2013 from 5.53% for the year ended December 31, 2012. The decrease in the yield on interest earning assets for the year ended December 31, 2013 reflects the decreased loan yields due primarily to lower contractual note rates as well as the effects of the overall discount accretion on all the acquired loan portfolios. The effect of discount accretion on net interest margin for the year ended December 31, 2013 and December 31, 2012 is as follows:

	Years Ended December 31,			
	2013		2012	
Net interest margin, excluding incremental accretion on purchased loans (1)	4.32	%	4.67	%
Impact on net interest margin from incremental accretion on purchased loans (1)	0.48		0.50	

Net interest margin	4.80 %	5.17 %

(1) The incremental accretion income represents the amount of income recorded on the purchased loans in excess of the contractual stated interest rate in the individual loan notes. This income results from the discount established at the time these loan portfolios were acquired and modified quarterly as a result of cash flow re-estimation.

Yield on interest earning assets was additionally reduced by nonaccruing loans. For the years ended December 31, 2013 and December 31, 2012, noncovered nonaccruing loans reduced the yield on interest earning assets by approximately five basis points and seven basis points, respectively. Nonaccrual noncovered loans totaled $7.7 million at December 31, 2013 compared to $13.2 million at December 31, 2012.

Interest income on taxable and nontaxable investment securities increased $165,000 to $3.5 million for the year ended December 31, 2013 from $3.3 million for the year ended December 31, 2012 due primarily to an increase in the average investment securities as a result of the NCB and Valley Acquisitions offset by lower yields earned on the investment securities in 2013 as a result of declining interest rates. The changes in average balances and interest income on other interest earning deposits had minimal impact on net interest margins for the years ended December 31, 2013 and 2012.

Total interest expense decreased by $810,000, or 17.9%, to $3.7 million for the year ended December 31, 2013 from $4.5 million for the year ended December 31, 2012. The decrease in interest expense was due to lower rates paid on interest bearing liabilities, reflecting the relatively low interest rate environment. The average rate paid on interest bearing liabilities decreased to 0.37% for the year ended December 31, 2013 from 0.50% for the year ended December 31, 2012. Total average interest bearing liabilities increased by $107.3 million, or 11.9%, to $1.01 billion for the year ended December 31, 2013 from $904.5 million for the year ended December 31, 2012. The increase in average interest bearing liabilities was due primarily to the NCB and Valley Acquisitions which had a combined fair value at the acquisitions dates of $267.5 million, offset by deposit run-off anticipated from the acquisitions and consolidation of existing bank branches.

Provision for Loan Losses.   The total provision for loan losses increased $1.7 million, or 82.1%, to $3.7 million for the year ended December 31, 2013 from $2.0 million for the year ended December 31, 2012. The Bank has established a comprehensive methodology for determining the allowance for loan losses and related provision for loan losses on loans. On a quarterly basis, the Bank performs an analysis taking into consideration pertinent factors underlying the quality of the loan portfolio. These factors include changes in the amount and composition of the loan portfolio, historical loss experience for various loan classes, changes in economic conditions, delinquency rates, a detailed analysis of individual loans on nonaccrual status, and other factors to determine the level of the allowance for loan losses and the related provision for loan losses.

The provision for loan losses on noncovered loans increased $214,000, or 13.6%, to $1.8 million for the year ended December 31, 2013 from $1.6 million for the year ended December 31, 2012. The increase in provision expense on noncovered loans was due primarily to the default of a few acquired borrowing relationships, offset partially by improvements in the environmental factors as well as lower net charge-offs on noncovered loans which decreased to $3.4 million during the year ended December 31, 2013 compared to $4.3 million during the year ended December 31, 2012. The ratio of net charge-offs for noncovered loan to average total noncovered loans outstanding was 0.32% for the year ended December 31, 2013 and 0.48% for the year ended December 31, 2012. Total noncovered loans at December 31, 2013 and 2012 were $1.17 billion and $940.7 million, respectively. The general allowance as a percentage of non-impaired loans was 1.63% and 2.11% at December 31, 2013 and 2012, respectively. The decrease in the percentage during the noted periods is due to reduction in the historical loss factors, change in the mix of loans, and a general improvement in the credit environment.

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The following table outlines the allowance for loan losses and related outstanding loan balances on noncovered loans at December 31, 2013 and 2012:

	December 31, 2013	December 31, 2012
	(Dollars in thousands)	
General Valuation Allowance:		
Allowance for loan losses on noncovered loans	$18,618	$19,558
Gross noncovered loan balance of non-impaired loans	1,140,967	927,485
Percentage	1.63 %	2.11 %
Specific Valuation Allowance:		
Allowance for loan losses on noncovered loans	$4,039	$4,684
Gross noncovered loan balance of impaired loans	29,869	13,219
Percentage	13.52 %	35.43 %
Total Allowance for Loan Losses on noncovered loans:		
Allowance for loan losses on noncovered loans	$22,657	$24,242
Gross noncovered loan balance	1,170,836	940,704
Percentage	1.94 %	2.58 %

The allowance for loan losses on noncovered loans decreased by $1.6 million, or 6.5%, to $22.7 million at December 31, 2013 from $24.2 million at December 31, 2012. As of December 31, 2013, the Bank identified $7.7 million of nonperforming noncovered loans and $22.1 million of performing restructured noncovered loans for a total of $29.9 million of impaired noncovered loans. Of these impaired loans, $17.4 million have no allowances for loan losses as their estimated collateral value or expected cash flow is equal to or exceeds their carrying costs. The remaining $12.4 million have related allowances for loan losses totaling $4.0 million. Based on the comprehensive methodology, management deemed the allowance for loan losses on noncovered loans of $22.7 million at December 31, 2013 (1.94% of total noncovered loans and 292.8% of nonperforming noncovered loans) appropriate to provide for probable incurred losses based on an evaluation of known and inherent risks in the loan portfolio at that date.

The provision for loan losses on covered loans increased $1.4 million, or 323.3%, to $1.9 million for the year ended December 31, 2013 compared to $446,000 for the year ended December 31, 2012. The provision for loan losses on covered loans recorded for the year ended December 31, 2013 was a result of several specific loan events. The Bank resolved one significant covered loan which generated approximately $585,000 in provision expense. The Bank also experienced significant collateral deficiencies on two borrowers which added an additional $1.6 million in provision expense. The impact of these events was partially offset by the general improvements in the remaining loans' expected cash flows which reduced the provision expense during the year ended December 31, 2013. The Bank recorded net charge-offs of $73,000 for the covered loans for the year ended December 31, 2013 as compared to $57,000 for the year ended December 31, 2012.

The allowance for loan losses on covered loans increased $1.8 million, or 41.7% to $6.2 million at December 31, 2013 from $4.4 million at December 31, 2012. The increase was primarily the result of the specific covered loans described above, offset by the general improvements in the expected cash flow of the covered loans.

Noninterest Income.   Total noninterest income increased $2.4 million, or 32.7%, to $9.7 million for the year ended December 31, 2013 compared to $7.3 million for the prior year.

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The components of the noninterest income and the changes from prior year are as follows:

	Years Ended December 31,			
	2013	2012	Change 2013 vs. 2012	Percentage Change
	(Dollars in thousands)			
Bargain purchase gain on bank acquisition	$399	$—	$399	100.0 %
Service charges and other fees	5,936	5,516	420	7.6
Merchant Visa income, net	862	685	177	25.8
Change in FDIC indemnification asset	(181)	(1,033)	852	82.5
Gain on sale of loans	142	295	(153)	(51.9)
Other income	2,493	1,809	684	37.8
Total noninterest income	$9,651	$7,272	$2,379	32.7 %

The change in FDIC indemnification asset includes amortization of the FDIC indemnification asset and increases to the FDIC indemnification asset as a result of decreases in projected remaining cash flows of the purchased covered loans. The increase in this income was primarily due to the $609,000 decrease in amortization expense of $1.3 million for the year ended December 31, 2013 compared to $1.9 million for the year ended December 31, 2012. The decrease in the amortization expense was primarily due to the declining indemnification asset balance. The balance of the indemnification asset at December 31, 2013 was $4.4 million compared to $7.1 million at December 31, 2012. The change in FDIC indemnification asset also increased due to an increase in the loan impairment, which was an increase of income of $1.1 million for the year ended December 31, 2013 compared to $843,000 in the prior year. Under the symmetrical accounting for acquired covered loans, an increase in the provision for loan losses for covered loans will generally have a related increase in the loan impairment. The provision for loan losses on covered loans was $1.9 million for the year ended December 31, 2013 compared to $446,000 for the year ended December 31, 2012.

Other income increased $684,000, or 37.8%, to $2.5 million for the year ended December 31, 2013 from $1.8 million for the year ended December 31, 2012 primarily due to the gain on sale of a bank branch of $596,000. The $420,000 increase in service charges and other fees to $5.9 million for the year ended December 31, 2013 compared to $5.5 million for the prior year was primarily the result of increased deposits and an expanded customer base. Deposits at December 31, 2013 increased to $1.40 billion at December 31, 2013 from $1.12 billion at December 31, 2012 primarily as a result of the NCB and Valley Acquisitions. The bargain purchase gain on bank acquisition of $399,000 for the year ended December 31, 2013 was the result of the NCB Acquisition in January 2013. See Note 2 - Business Combinations of the Notes to Consolidated Financial Statements in "Item 8. Financial Statements and Supplementary Data" for additional information on the NCB and Valley Acquisitions.

Noninterest Expense. Noninterest expense increased $9.1 million or 18.1% to $59.5 million for the year ended December 31, 2013 compared to $50.4 million for the year ended December 31, 2012.

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The following table presents the key components of noninterest expense and the change from prior year:

	Years Ended December 31,				
	2013	2012	Change 2013 vs. 2012	Percentage Change	
	(Dollars in thousands)				
Compensation and employee benefits	$31,612	$29,020	$2,592	8.9	%
Occupancy and equipment	9,724	7,365	2,359	32.0	
Data processing	4,806	2,555	2,251	88.1	
Marketing	1,598	1,517	81	5.3	