



# BNCCORP

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## **Quarterly Report**

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**For the quarter ended March 31, 2011**

**BNCCORP, INC.**

**(OTC Markets:BNCC)**

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**BNCCORP, INC.**  
**INDEX TO QUARTERLY REPORT**  
**March 31, 2011**

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# FINANCIAL INFORMATION

## Item 1. Financial Statements

### BNCCORP, INC. AND SUBSIDIARIES

#### Consolidated Balance Sheets

(In thousands, except share data)

ASSETS	March 31, 2011 (unaudited)	December 31, 2010
CASH AND CASH EQUIVALENTS	\$ 86,188	\$ 112,847
INVESTMENT SECURITIES AVAILABLE FOR SALE	213,556	137,032
FEDERAL RESERVE BANK AND FEDERAL HOME LOAN BANK STOCK	2,882	2,862
LOANS HELD FOR SALE-MORTGAGE BANKING	20,141	29,116
PARTICIPATING INTERESTS IN MORTGAGE LOANS	1,705	4,888
LOANS AND LEASES HELD FOR INVESTMENT	323,713	350,501
ALLOWANCE FOR CREDIT LOSSES	(14,176)	(14,765)
Net loans and leases held for investment	311,242	340,624
OTHER LOANS HELD FOR SALE, net	-	70,501
OTHER REAL ESTATE, net	12,506	12,706
PREMISES AND EQUIPMENT, net	16,510	16,684
INTEREST RECEIVABLE	2,118	2,138
OTHER ASSETS	18,503	19,790
PREMISES AND EQUIPMENT HELD FOR SALE, net	-	2,769
Total assets	<u>\$ 683,646</u>	<u>\$ 747,069</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
DEPOSITS:		
Non-interest-bearing	\$ 123,774	\$ 91,478
Interest-bearing –		
Savings, interest checking and money market	253,831	243,332
Time deposits \$100,000 and over	77,506	39,580
Time deposits under \$100,000	147,532	179,275
	<u>602,643</u>	<u>553,665</u>
Non-interest-bearing held for sale	-	34,610
Interest-bearing held for sale	-	72,836
Total deposits	<u>602,643</u>	<u>661,111</u>
SHORT-TERM BORROWINGS	13,684	16,329
FEDERAL HOME LOAN BANK ADVANCES	-	-
OTHER BORROWINGS	-	-
GUARANTEED PREFERRED BENEFICIAL INTERESTS IN COMPANY'S SUBORDINATED DEBENTURES	24,466	24,134
ACCRUED INTEREST PAYABLE	867	852
ACCRUED EXPENSES	3,936	4,704
OTHER LIABILITIES	2,644	2,618
Total liabilities	<u>648,240</u>	<u>709,748</u>
STOCKHOLDERS' EQUITY:		
Preferred stock, \$.01 par value – Authorized 2,000,000 shares:		
Preferred Stock - 5% Series A 20,093 shares outstanding;	19,467	19,411
Preferred Stock - 9% Series B 1,005 shares outstanding;	1,069	1,075
Common stock, \$.01 par value – Authorized 35,000,000 shares; 3,302,926 and 3,304,339 shares issued and outstanding	33	33
Capital surplus – common stock	27,083	27,036
Retained earnings (deficit)	(7,088)	(7,322)
Treasury stock (365,727 and 364,314 shares, respectively)	(5,072)	(5,069)
Accumulated other comprehensive gain (loss), net	(86)	2,157
Total stockholders' equity	<u>35,406</u>	<u>37,321</u>
Total liabilities and stockholders' equity	<u>\$ 683,646</u>	<u>\$ 747,069</u>

See accompanying notes to consolidated financial statements.

**BNCCORP, INC. AND SUBSIDIARIES**

Consolidated Statements of Operations  
For the Three Months Ended March 31,  
(In thousands, except per share data, unaudited)

	<u>2011</u>	<u>2010</u>
INTEREST INCOME:		
Interest and fees on loans	\$ 5,060	\$ 6,533
Interest and dividends on investments		
Taxable	1,788	2,705
Tax-exempt	23	23
Dividends	36	28
Total interest income	<u>6,907</u>	<u>9,289</u>
INTEREST EXPENSE:		
Deposits	1,380	2,536
Short-term borrowings	35	16
Federal Home Loan Bank advances	-	113
Other borrowings	-	-
Subordinated debentures	332	286
Total interest expense	<u>1,747</u>	<u>2,951</u>
Net interest income	5,160	6,338
PROVISION FOR CREDIT LOSSES	600	2,000
NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES	<u>4,560</u>	<u>4,338</u>
NON-INTEREST INCOME:		
Bank charges and service fees	560	617
Wealth management revenues	385	571
Mortgage banking revenues, net	2,063	2,185
Gains (losses) on sales of loans, net	488	(2)
Gains on sales of securities, net	361	2,505
Other	179	410
Total non-interest income	<u>4,036</u>	<u>6,286</u>
NON-INTEREST EXPENSE:		
Salaries and employee benefits	4,013	4,100
Professional services	737	765
Data processing fees	685	602
Occupancy	586	731
Regulatory costs	516	385
Other real estate costs	321	454
Marketing and promotion	314	330
Depreciation and amortization	297	331
Office supplies and postage	145	150
Other	409	634
Total non-interest expense	<u>8,023</u>	<u>8,482</u>
Income before income taxes	573	2,142
Income tax benefit	-	(48)
NET INCOME	573	2,190
Preferred stock costs	(339)	(324)
Net income available to common shareholders	<u>\$ 234</u>	<u>\$ 1,866</u>
Basic earnings per common share	<u>\$ 0.07</u>	<u>\$ 0.57</u>
Diluted earnings per common share	<u>\$ 0.07</u>	<u>\$ 0.57</u>

See accompanying notes to consolidated financial statements.

**BNCCORP, INC. AND SUBSIDIARIES**  
Consolidated Statements of Comprehensive Income  
For the Three Months Ended March 31,  
(In thousands, unaudited)

	<b>2011</b>	<b>2010</b>
NET INCOME	\$ 573	\$ 2,190
Amortization of deferred gain in other comprehensive income	\$ -	\$ (40)
Unrealized gain (loss) on securities available for sale	(1,882)	6,616
Reclassification adjustment for gains included in net income	<u>(361)</u>	<u>(2,505)</u>
Other comprehensive income (loss), before tax	(2,243)	4,071
Income tax expense related to items of other comprehensive income	<u>-</u>	<u>-</u>
Other comprehensive income (loss)	<u>(2,243)</u> <u>(2,243)</u>	<u>4,071</u> <u>4,071</u>
<b>TOTAL COMPREHENSIVE INCOME (LOSS)</b>	<u><u>\$ (1,670)</u></u>	<u><u>\$ 6,261</u></u>

See accompanying notes to consolidated financial statements.

**BNCCORP, INC. AND SUBSIDIARIES**  
Consolidated Statements of Stockholders' Equity  
For the Three Months Ended March 31,  
(In thousands, except share data, unaudited)

	<u>Preferred Stock</u>		<u>Common Stock</u>		<u>Capital Surplus</u>			<u>Accumulated Other Comprehensive</u>		<u>Total</u>
	<u>Shares</u>	<u>Amount</u>	<u>Shares</u>	<u>Amount</u>	<u>Common Stock</u>	<u>Retained Earnings</u>	<u>Treasury Stock</u>	<u>Income (Loss)</u>		
	BALANCE, December 31, 2009	21,098	\$ 20,285	3,290,219	\$ 33	\$ 26,885	\$ 16,078	\$ (5,068)	\$ (948)	
Net income	-	-	-	-	-	2,190	-	-	2,190	
Other comprehensive gain	-	-	-	-	-	-	-	4,071	4,071	
Preferred stock amortization, net	-	50	-	-	-	(50)	-	-	-	
Dividend on preferred stock	-	-	-	-	-	(274)	-	-	(274)	
Impact of share-based compensation	-	-	-	-	8	-	-	-	8	
BALANCE, March 31, 2010	21,098	\$ 20,335	3,290,219	\$ 33	\$ 26,893	\$ 17,944	\$ (5,068)	\$ 3,123	\$ 63,260	
BALANCE, December 31, 2010	21,098	\$ 20,486	3,304,339	\$ 33	\$ 27,036	\$ (7,322)	\$ (5,069)	\$ 2,157	\$ 37,321	
Net income	-	-	-	-	-	573	-	-	573	
Other comprehensive loss	-	-	-	-	-	-	-	(2,243)	(2,243)	
Preferred stock amortization, net	-	50	-	-	-	(50)	-	-	-	
Dividend on preferred stock	-	-	-	-	-	(289)	-	-	(289)	
Impact of share-based compensation	-	-	(1,413)	-	47	-	(3)	-	44	
BALANCE, March 31, 2011	21,098	\$ 20,536	3,302,926	\$ 33	\$ 27,083	\$ (7,088)	\$ (5,072)	\$ (86)	\$ 35,406	

See accompanying notes to consolidated financial statements.

**BNCCORP, INC. AND SUBSIDIARIES**  
Consolidated Statements of Cash Flows  
For the Three Months Ended March 31,  
(In thousands, unaudited)

	<b>2011</b>	<b>2010</b>
<b>OPERATING ACTIVITIES:</b>		
Net income	\$ 573	\$ 2,190
Adjustments to reconcile net income to net cash provided by operating activities -		
Provision for credit losses	600	2,000
Provision for other real estate losses	200	394
Depreciation and amortization	297	331
Net amortization of premiums and (discounts) on investment securities and subordinated debentures	299	(242)
Share-based compensation	47	8
Change in interest receivable and other assets, net	451	6,489
Loss on sale of other real estate	-	144
Bank premises and equipment, net charges associated with branch closure	-	101
Gain on sale of branch	-	(403)
Gain on sale of bank premises and equipment	(2)	-
Net realized gain on sales of investment securities	(361)	(2,505)
Provision (benefit) for deferred income taxes	-	(48)
Change in other liabilities, net	167	(507)
Funding of originations of loans held for sale	(101,867)	(95,835)
Proceeds from sales of loans held for sale	111,370	99,803
Fair value adjustment for loans held for sale	(527)	(246)
Proceeds from sales of loans	3,818	-
(Gains) losses on sales of loans, net	(488)	2
Net cash provided by operating activities	14,577	11,676
<b>INVESTING ACTIVITIES:</b>		
Purchases of investment securities	(108,901)	-
Proceeds from sales of investment securities	16,903	26,620
Proceeds from maturities of investment securities	13,292	14,421
Purchases of Federal Reserve and Federal Home Loan Bank Stock	(20)	(450)
Sales of Federal Reserve and Federal Home Loan Bank Stock	-	668
Net decrease (increase) in participating interests in mortgage loans	3,183	2,448
Cash used to finance divestiture	(10,966)	-
Net decrease (increase) in loans held for investment	27,083	10,677
Proceeds from sales of other real estate	-	358
Proceeds from sales of bank premises and equipment	2,773	105
Additions to bank premises and equipment	(125)	(57)
Net cash (used in) provided by investing activities	(56,778)	54,790

See accompanying notes to consolidated financial statements.

**BNCCORP, INC. AND SUBSIDIARIES**  
Consolidated Statements of Cash Flows, continued  
For the Three Months Ended March 31,  
(In thousands, unaudited)

	<u>2011</u>	<u>2010</u>
FINANCING ACTIVITIES:		
Net increase (decrease) in deposits	18,186	(24,278)
Net increase (decrease) in short-term borrowings	(2,644)	(1,104)
Repayments of Federal Home Loan Bank advances	-	(15,000)
Net cash provided by (used in) financing activities	<u>15,542</u>	<u>(40,382)</u>
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(26,659)	26,084
CASH AND CASH EQUIVALENTS, beginning of period	<u>112,847</u>	<u>35,362</u>
CASH AND CASH EQUIVALENTS, end of period	<u>\$ 86,188</u>	<u>\$ 61,446</u>
SUPPLEMENTAL CASH FLOW INFORMATION:		
Interest paid	<u>\$ 1,732</u>	<u>\$ 2,895</u>
Income taxes received	<u>\$ (15)</u>	<u>\$ (6,565)</u>
SUPPLEMENTAL DISCLOSURE OF NONCASH INVESTING AND FINANCING ACTIVITIES:		
Additions to other real estate in settlement of loans	<u>\$ -</u>	<u>\$ -</u>
Loans sold in divestiture	<u>\$ 65,688</u>	<u>\$ -</u>
Deposits transferred in divestiture	<u>\$ 76,654</u>	<u>\$ -</u>

See accompanying notes to consolidated financial statements.

**BNCCORP, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Unaudited)  
March 31, 2011

**NOTE 1 – Organization of Operations, BNCCORP, INC.**

BNCCORP, INC. (BNCCORP) is a registered bank holding company incorporated under the laws of Delaware. It is the parent company of BNC National Bank (together with its wholly owned subsidiary, BNC Insurance Services, Inc., collectively the Bank). The Company operates community banking and wealth management businesses in Arizona, Minnesota and North Dakota from 17 locations. The Bank also conducts mortgage banking from 10 locations in Arizona, Minnesota, Iowa, Kansas, Nebraska and Missouri.

The accounting and reporting policies of BNCCORP and its subsidiaries (collectively, the Company) conform to accounting principles generally accepted in the United States of America and general practices within the financial services industry. The consolidated financial statements included herein are for BNCCORP and its subsidiaries. All significant intercompany transactions and balances have been eliminated in consolidation.

**NOTE 2 – Basis of Presentation and Accounting Policies**

The accompanying interim consolidated financial statements have been prepared by the Company, in accordance with accounting principles generally accepted in the United States of America for interim financial information. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted. The Company believes that the disclosures made are adequate to make the information presented not misleading.

The unaudited consolidated financial statements as of March 31, 2011 include, in the opinion of management, all adjustments, consisting solely of normal recurring adjustments, necessary for a fair presentation of the financial results for the respective interim periods and are not necessarily indicative of results of operations to be expected for the entire fiscal year.

The accompanying interim consolidated financial statements have been prepared under the presumption that users of the interim consolidated financial information have either read or have access to the audited consolidated financial statements for the year ended December 31, 2010. Accordingly, footnote disclosures which would substantially duplicate the disclosures contained in the December 31, 2010 audited consolidated financial statements have been omitted from these interim consolidated financial statements. It is suggested that these interim consolidated financial statements be read in conjunction with the audited consolidated financial statements for the year ended December 31, 2010 and the notes thereto.

The Company's critical accounting policies are unchanged since December 31, 2010.

**Recently Issued or Adopted Accounting Standards**

FASB ASU 2010-06, *Fair Value Measurements and Disclosures (Topic 820), Improving Disclosures and Fair Value Measurements*, requires new investment fair market disclosures in order to increase the transparency in the financial reporting of investments. The new disclosures and clarifications of existing disclosures are effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements in the rollforward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. The adoption of this ASU in 2010 did not have a material impact on the Company's consolidated financial statements.

FASB ASU 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*, requires significant new disclosures about the allowance for credit losses and the credit quality of financing receivables. The requirements are intended to enhance transparency regarding credit losses and the credit quality of loan and lease receivables. Under this statement, allowance for credit losses and fair value

are to be disclosed by portfolio segment, while credit quality information, impaired financing receivables and nonaccrual status are to be presented by class of financing receivable. Disclosure of the nature and extent, the financial impact and segment information of troubled debt restructurings will also be required. The disclosures are to be presented at the level of disaggregation that management uses when assessing and monitoring the portfolio's risk and performance. This ASU is effective for interim and annual reporting periods after December 15, 2010 for public companies and on or after December 15, 2011 for non-public companies.

FASB ASU No. 2010-18, *Receivables (Topic 310): Effect of a Loan Modification When the Loan Is Part of a Pool That is Accounted for as a Single Asset*, clarifies the accounting for acquired loans that have evidence of a deterioration in credit quality since origination (referred to as "Subtopic 310-30 Loans"). Under this ASU, an entity may not apply troubled debt restructuring ("TDR") accounting guidance to individual Subtopic 310-30 loans that are part of a pool, even if the modification of those loans would otherwise be considered a troubled debt restructuring. Once a pool is established, individual loans should not be removed from the pool unless the entity sells, forecloses, or writes off the loan. Entities would continue to consider whether the pool of loans is impaired if expected cash flows for the pool change. Subtopic 310-30 loans that are accounted for individually would continue to be subject to TDR accounting guidance. A one-time election to terminate accounting for loans as a pool, which may be made on a pool-by-pool basis, is provided upon adoption of the ASU. This ASU is effective for the first interim or annual period ending on or after July 15, 2010 and should be applied prospectively. Adoption of this ASU did not have a material effect on the Company's consolidated financial statements.

FASB ASU No. 2011-02, *A Creditor's Determination of Whether a Restructuring is a Troubled Debt Restructuring*, clarifies when the restructuring of a receivable should be considered a troubled debt restructuring (TDR). FASB issued the guidance in response to constituents' concerns that creditors were inconsistently applying the guidance for indentifying TDRs. The ASU provides additional guidance for determining whether the creditor has granted a concession and whether the debtor is experiencing financial difficulty. The ASU generally will result in creditors identifying more TDRs. For nonpublic companies, this ASU is effective for annual periods ending after December 12, 2012, including interim periods within those annual periods.

## NOTE 3 – Regulatory Capital and Current Operating Environment

Actual capital amounts and ratios of BNCCORP and the Bank are presented in the tables below (dollars in thousands):

	Actual		To be Well Capitalized	
	Amount	Ratio	Amount	Ratio
<b>March 31, 2011</b>				
<b>Total Capital</b> (to risk-weighted assets):				
Consolidated	\$ 64,906	16.79 %	\$ N/A	N/A
BNC National Bank	63,006	16.32	49,346	10.0 %
<b>Tier 1 Capital</b> (to risk-weighted assets):				
Consolidated	47,323	12.24	N/A	N/A
BNC National Bank	58,066	15.04	29,608	6.0
<b>Tier 1 Capital</b> (to average assets):				
Consolidated	47,323	6.23	N/A	N/A
BNC National Bank	58,066	7.67	37,865	5.0
<b>Tangible Capital</b> (to total assets):				
Consolidated tangible equity	35,318	5.17	N/A	N/A
BNC National Bank	58,347	8.56	N/A	N/A
<b>Tangible Common Capital</b> (to total assets):				
Consolidated tangible common equity	14,779	2.16	N/A	N/A
<b>December 31, 2010</b>				
<b>Total Capital</b> (to risk-weighted assets):				
Consolidated	\$ 65,601	13.23 %	\$ N/A	N/A
BNC National Bank	63,380	12.80	49,515	10.0 %
<b>Tier 1 Capital</b> (to risk-weighted assets):				
Consolidated	46,885	9.46	N/A	N/A
BNC National Bank	57,106	11.53	29,709	6.0
<b>Tier 1 Capital</b> (to average assets):				
Consolidated	46,885	6.17	N/A	N/A
BNC National Bank	57,106	7.53	37,932	5.0
<b>Tangible Capital</b> (to total assets):				
Consolidated tangible equity	37,226	4.98	N/A	N/A
BNC National Bank	59,622	8.00	N/A	N/A
<b>Tangible Common Capital</b> (to total assets):				
Consolidated tangible common equity	16,740	2.24	N/A	N/A

In the current operating environment, management believes banking entities are regularly required to maintain capital ratios in excess of the statutory amounts required to remain well capitalized. We are managing capital accordingly.

As of the most recent notification, the OCC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. Management believes the Bank remains well capitalized through the date for which subsequent events have been evaluated.

In February of 2010, the Bank entered into an agreement with the OCC with three articles primarily pertaining to credit administration. The agreement requires the Bank's board of directors to address three articles that can be summarized as follows:

- (1) Develop, and implement a written program to identify and monitor credit and underwriting exceptions from loan policy;
- (2) Adopt, implement and ensure adherence to a written asset diversification program that limits concentrations of assets to prescribed limits; and
- (3) Adopt, implement and ensure adherence to work out plans designed to reduce criticized assets. The work out plans are to be updated quarterly.

Management believes policies and procedures implemented in 2010 adequately addressed the articles summarized above. However, the OCC will need more time to evaluate the effectiveness of our policies and procedures before they will remove the articles.

In April 2010, BNCCORP entered into a memorandum of understanding that restricts dividend payments and/or payment of interest on the holding company's common stock, preferred stock, and debt. Payments of this nature are not permitted without prior written approval from the Federal Reserve Bank. The memorandum of understanding also restricts the holding company from increasing debt without prior written consent from the Federal Reserve.

#### **NOTE 4. Fraud Loss on Assets Serviced by Others**

As previously reported, the Company discovered fraudulent activity in April of 2010 by an external company that was servicing residential mortgage loans for BNC. Subsequently, the Company and its advisors have been diligently addressing this matter. Our internal and external investigations have confirmed that this fraudulent activity was limited to this external servicing company and that no bank employees were involved in or were aware of this wrongful conduct by the servicing company. As such, we believe these losses are not indicative of other credit quality problems within our loan portfolio.

In 2010, we submitted claims under our fidelity insurance policies seeking to recover the insured portion of these losses. The policies together provide for total coverage of \$15 million. However, in the fourth quarter of 2010, our insurance carriers commenced a declaratory judgment action against the Company in an Arizona federal court seeking a judicial determination that the losses associated with the servicing fraud are not covered by the policies. We have subsequently counter sued the insurance carriers for failure to honor the policies and for acting in bad faith. We intend to vigorously pursue our claims to recover amounts due under the insurance policies and for losses incurred as a result of the carriers acting in bad faith. While management believes we have strong claims, there can be no assurances as to the outcome of this litigation, or if we will recover all or any portion of the insured amounts.

#### **NOTE 5. Divestiture**

On March 11, 2011, the previously announced sale of certain assets and liabilities was consummated. The sale included BNC's Scottsdale, Arizona branch premises; certain Arizona-based deposit accounts and loans; and certain deposit accounts and loans of BNC's offices in Minneapolis and Golden Valley, Minnesota. BNC continues to offer a full range of banking services in the Arizona and Minnesota markets following the sale.

The sale did not affect our North Dakota, wealth management, or mortgage banking operations.

As of December 31, 2010, the assets and liabilities included in the divestiture were classified as held for sale. As of December 31, 2010, the carrying value of the loans held for sale related to the divestiture was \$70.5 million. The total loans held for sale as of December 31, 2010 was \$72.2 million and the allowance for losses allocated to these loans at year end was \$1.7 million. The carrying value of premises and equipment held for sale related to the divestiture was \$2.8 million. The carrying value of deposits held for sale related to the divestiture was \$107.5 million.

There was no significant gain incurred as a result of the divestiture.

## NOTE 6 – Other Real Estate

Other real estate (ORE) includes property acquired through foreclosure, property in judgment and in-substance foreclosures. ORE is carried at fair value less estimated selling costs. Each property is evaluated regularly and the amounts provided to decrease the carrying amount are included in non-interest expense. A summary of the activity related to ORE is presented below (in thousands):

	<b>Three Months Ended March 31,</b>	
	<b>2011</b>	<b>2010</b>
<b>Balance, beginning of period</b>	\$ 12,706	\$ 7,253
Transfers from nonperforming loans	-	-
Real estate sold	-	(358)
Net gains (losses) on sale of assets	-	(144)
Provision	(200)	(394)
<b>Balance, end of period</b>	<b>\$ 12,506</b>	<b>\$ 6,357</b>

## NOTE 7 – Earnings Per Share

The following table shows the amounts used in computing per share results for the three months ended March 31 (in thousands, except share data):

	<b>2011</b>	<b>2010</b>
Denominator for basic earnings per share:		
Average common shares outstanding	3,283,839	3,281,719
Dilutive common stock options	-	-
Denominator for diluted earnings per share	3,283,839	3,281,719
Numerator:		
Net income	\$ 573	\$ 2,190
Preferred stock costs	(339)	(324)
Net income available to common shareholders	\$ 234	\$ 1,866
Basic earnings per common share	\$ 0.07	\$ 0.57
Diluted earnings per common share	\$ 0.07	\$ 0.57

For the three months ended March 31, 2011 and 2010, there were 237,700 options and 281,700 options outstanding, respectively, excluded from the computation of diluted EPS because their exercise prices were higher than the average price of BNCCORP's common stock for the period and are considered anti-dilutive.

## NOTE 8 – Share-Based Compensation

The Company may grant share-based compensation at prices equal to the fair value of the stock at the grant date. The Company has four share-based plans for certain key employees and directors whereby shares of common stock have been reserved for awards in the form of stock options or restricted stock awards. The plans are as follows:

	<b>1995</b>	<b>2002</b>	<b>2006</b>	<b>2010</b>
Total Shares Available	78,251	-	15,800	250,000
Maximum Restricted Shares Available	78,251	-	15,800	35,000

The Company granted 240,000 stock options in late March of 2010. The stock options have a two year vesting period and a ten year contractual term. The exercise price is equal to the market price on grant date, which was \$3.00. The fair value of each share option is estimated on the date of grant using a Black-Scholes methodology with the assumptions noted below:

Expected volatility	32.56%
Dividend yield	0.00%
Risk-free interest rate – seven –year treasury yield	3.201%
Expected life of stock option	7 years

The Company recognized share-based compensation expense of \$35,000 for the three month period ending March 31, 2011 relating to share options. The Company recognized share-based compensation expense of \$0 for the three month period ended March 31, 2010 relating to share options. At March 31, 2011, the Company had \$134,000 of unamortized compensation cost related to non-vested stock options granted.

BNC has a policy of issuing shares from treasury shares already held when options are exercised.

Following is a summary of fully vested stock options and options expected to vest as of March 31, 2011:

	<u>Stock Options Outstanding</u>	<u>Stock Options Currently Exercisable</u>	<u>Stock Options Vested and Expected to Vest</u>
Number	237,700	123,700	237,700
Weighted-average exercise price	\$3.17	\$3.32	\$3.17
Weighted-average remaining contractual term	8.7 years	8.4 years	8.7 years

There were 0 shares of restricted stock granted in the three month period ending March 31, 2011. The Company recognized share-based compensation expense of \$12,000 related to restricted stock for the three month period ended March 31, 2011. The Company recognized share-based compensation expense of \$8,000 related to restricted stock for the three month period ended March 31, 2010.

At March 31, 2011, the Company had \$65,000 of unamortized restricted stock compensation expense. All of this expense will be amortized by September 1, 2013. The cost of restricted stock granted is recognized over the vesting period, which is generally three or more years.

## NOTE 9 – Investment Securities Available for Sale

Investment securities have been classified in the consolidated balance sheets according to management's intent. The Company had no securities designated as trading or held-to-maturity in its portfolio at March 31, 2011 or December 31, 2010. The carrying amount of available-for-sale securities and their approximate fair values were as follows (in thousands):

	<b>March 31, 2011</b>			
	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	<b>Estimated Fair Value</b>
U.S. government agency mortgage-backed securities guaranteed by GNMA	\$ 925	\$ 45	\$ -	\$ 970
U.S. government agency mortgage-backed securities issued by FNMA	1,841	108	(2)	1,947
Collateralized mortgage obligations guaranteed by GNMA	158,208	417	(1,389)	157,236
Collateralized mortgage obligations issued by FNMA or FHLMC	17,042	100	(195)	16,947
Other collateralized mortgage obligations	33,060	1,349	(142)	34,267
State and municipal bonds	1,934	255	-	2,189
	<u>\$ 213,010</u>	<u>\$ 2,274</u>	<u>\$ (1,728)</u>	<u>\$ 213,556</u>

  

	<b>December 31, 2010</b>			
	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	<b>Estimated Fair Value</b>
U.S. government agency mortgage-backed securities guaranteed by GNMA	\$ 965	\$ 35	\$ -	\$ 1,000
U.S. government agency mortgage-backed securities issued by FNMA	1,863	116	(1)	1,978
Collateralized mortgage obligations guaranteed by GNMA	89,056	908	(275)	89,689
Collateralized mortgage obligations issued by FNMA or FHLMC	930	67	-	997
Other collateralized mortgage obligations	39,518	1,889	(152)	41,255
State and municipal bonds	1,911	202	-	2,113
	<u>\$ 134,243</u>	<u>\$ 3,217</u>	<u>\$ (428)</u>	<u>\$ 137,032</u>

The amortized cost and estimated fair market value of available-for-sale securities classified according to their contractual maturities at March 31, 2011 were as follows (in thousands):

	<b>Amortized Cost</b>	<b>Estimated Fair Value</b>
Due in one year or less	\$ -	-
Due after one year through five years	-	-
Due after five years through ten years	11,094	11,478
Due after ten years	201,916	202,078
Total	<u>\$ 213,010</u>	<u>213,556</u>

Actual maturities may differ from the contractual maturities shown above as a result of prepayments.

The following table shows the Company's investments' gross unrealized losses and fair value; aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position (dollars are in thousands):

**March 31, 2011**

Description of Securities	Less than 12 months			12 months or more			Total		
	#	Fair Value	Unrealized Loss	#	Fair Value	Unrealized Loss	#	Fair Value	Unrealized Loss
	U.S. government agency mortgage-backed securities guaranteed by GNMA	-	\$ -	\$ -	-	\$ -	\$ -	-	\$ -
U.S. government agency mortgage-backed securities issued by FNMA	-	-	-	1	56	(2)	1	56	(2)
Collateralized mortgage obligations guaranteed by GNMA	23	114,361	(1,389)	-	-	-	23	114,361	(1,389)
Collateralized mortgage obligations issued by FNMA or FHLMC	3	10,736	(195)	-	-	-	3	10,736	(195)
Other collateralized mortgage obligations	3	443	(3)	1	6,583	(139)	4	7,026	(142)
State and municipal bonds	-	-	-	-	-	-	-	-	-
<b>Total temporarily impaired securities</b>	<b>29</b>	<b>\$ 125,540</b>	<b>\$ (1,587)</b>	<b>2</b>	<b>\$ 6,639</b>	<b>\$ (141)</b>	<b>31</b>	<b>\$ 132,179</b>	<b>\$ (1,728)</b>

**December 31, 2010**

Description of Securities	Less than 12 months			12 months or more			Total		
	#	Fair Value	Unrealized Loss	#	Fair Value	Unrealized Loss	#	Fair Value	Unrealized Loss
	U.S. government agency mortgage-backed securities guaranteed by GNMA	-	\$ -	\$ -	-	\$ -	\$ -	-	\$ -
U.S. government agency mortgage-backed securities issued by FNMA	-	-	-	1	57	(1)	1	57	(1)
Collateralized mortgage obligations guaranteed by GNMA	5	19,822	(275)	-	-	-	5	19,822	(275)
Collateralized mortgage obligations issued by FNMA or FHLMC	-	-	-	-	-	-	-	-	-
Other collateralized mortgage obligations	2	339	(3)	2	7,276	(149)	4	7,615	(152)
State and municipal bonds	-	-	-	-	-	-	-	-	-
<b>Total temporarily impaired securities</b>	<b>7</b>	<b>\$ 20,161</b>	<b>\$ (278)</b>	<b>3</b>	<b>\$ 7,333</b>	<b>\$ (150)</b>	<b>10</b>	<b>\$ 27,494</b>	<b>\$ (428)</b>

Management regularly evaluates each security with unrealized losses to determine whether losses are other-than-temporary. When the evaluation is performed, management considers several factors including, but not limited to, the amount of the unrealized loss, the length of time the security has been in a loss position, guarantees provided by third parties, ratings on the security, cash flow from the security, the level of credit support provided by subordinate tranches, and the collateral underlying the security.

We have been receiving principal payments on all non-agency securities since acquisition and the current credit support on all securities is higher than the credit support provided at the inception of the bond.

For the non-agency securities with unrealized losses at March 31, 2011, the collateral is generally based on loans originated between 2003 and 2004, and as a result the loan to value ratios of the underlying loans generally indicates risk of loss is relatively low. For the securities that were structured in 2008 or later, we own early sequential bonds that are currently paying down and the securities are senior to subordinated securities. Interest payments on the subordinated securities are redirected to reduce principal on our securities until the securities have been paid in full.

All securities in an unrealized loss position are investment grade. For one security that had been in an unrealized loss position for a longer period, we obtained a credit surveillance report that provides prospective analysis of the security's performance under various scenarios. The credit surveillance report does not currently project credit losses on this security.

There were no securities that management concluded were other-than-temporarily impaired at March 31, 2011.

## **NOTE 10 – Fair Value Measurements**

FASB ASC 820, *Fair Value Measurements and Disclosures*, defines fair value and establishes a framework for measuring fair value of assets and liabilities using a hierarchy system consisting of three levels based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. These levels are:

Level 1: Valuation is based upon quoted prices for identical instruments traded in active markets that the Company has the ability to access.

Level 2: Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active and model-based valuation techniques for which significant assumptions are observable in the market.

Level 3: Valuation is generated from model-based techniques that use significant assumptions not observable in the market and are used only to the extent that observable inputs are not available. These unobservable assumptions reflect our own estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include use of option pricing models, discounted cash flow models and similar techniques.

The following tables summarize the financial assets and liabilities of the Company for which fair values are determined on a recurring basis (in thousands):

	<b>Carrying Value at March 31, 2011</b>			
	<b>Total</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
<b>ASSETS</b>				
Securities available for sale	\$ 213,556	\$ -	\$ 213,556	\$ -
Loans held for sale	20,141	-	20,141	-
Commitments to originate mortgage loans	1,351	-	1,351	-
Total assets at fair value	<u>\$ 235,048</u>	<u>\$ -</u>	<u>\$ 235,048</u>	<u>\$ -</u>
<b>LIABILITIES</b>				
Commitments to sell mortgage loans	\$ 1,860	\$ -	\$ 1,860	\$ -
Total liabilities at fair value	<u>\$ 1,860</u>	<u>\$ -</u>	<u>\$ 1,860</u>	<u>\$ -</u>

	<b>Carrying Value at December 31, 2010</b>			
	<b>Total</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
<b>ASSETS</b>				
Securities available for sale	\$ 137,032	\$ -	\$ 137,032	\$ -
Loans held for sale	29,116	-	29,116	-
Commitments to originate mortgage loans	488	-	488	-
Total assets at fair value	<u>\$ 166,636</u>	<u>\$ -</u>	<u>\$ 166,636</u>	<u>\$ -</u>
<b>LIABILITIES</b>				
Commitments to sell mortgage loans	\$ 470	\$ -	\$ 470	\$ -
Total liabilities at fair value	<u>\$ 470</u>	<u>\$ -</u>	<u>\$ 470</u>	<u>\$ -</u>

At the beginning of the period, all assets and liabilities valued at fair value on a recurring basis were considered to be Level 2. There were no transfers into or out of Level 2 during the period.

Changes in the fair value of assets and liabilities determined on a recurring basis had no net impact on our Consolidated Statements of Operations for the three month period ending March 31, 2011 and March 31, 2010.

The Company may also be required from time to time to measure certain other financial assets at fair value on a nonrecurring basis in accordance with U.S. generally accepted accounting principles. These adjustments to fair value usually result from the application of the lower-of-cost-or market accounting or write-down of individual assets. For assets measured at fair value on a nonrecurring basis, the following tables provide the level of valuation assumptions used to determine the carrying value (in thousands):

	<b>Carrying Value at March 31, 2011</b>				<b>Three Months Ended</b>
	<b>Total</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>March 31, 2011</b>
Impaired loans <sup>(1)</sup>	\$ 16,564	\$ -	\$ 16,564	\$ -	\$ (366)
Other real estate <sup>(2)</sup>	12,506	-	12,506	-	(200)
Total	<u>\$ 29,070</u>	<u>\$ -</u>	<u>\$ 29,070</u>	<u>\$ -</u>	<u>\$ (566)</u>

	<b>Carrying Value at December 31, 2010</b>				<b>Twelve Months Ended</b>
	<b>Total</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>December 31, 2010</b>
Impaired loans <sup>(1)</sup>	\$ 15,152	\$ -	\$ 15,152	\$ -	\$ (2,260)
Other real estate <sup>(2)</sup>	12,706	-	12,706	-	(2,509)
<b>Total</b>	<b>\$ 27,858</b>	<b>\$ -</b>	<b>\$ 27,858</b>	<b>\$ -</b>	<b>\$ (4,769)</b>

(1) Represents the carrying value and related write-downs of loans based on the appraised value of the collateral.

(2) Represents the fair value of the collateral less estimated selling costs and is based upon appraised values.

At the beginning of the period, all assets and liabilities valued at fair value on a nonrecurring basis were considered to be Level 2. There were no transfers into or out of Level 2 during the period.

## NOTE 11. Fair Value of Financial Instruments

The estimated fair values of the Company's financial instruments are as follows (in thousands):

	March 31, 2011		December 31, 2010	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
<b>Assets:</b>				
Cash and cash equivalents	\$ 86,188	\$ 86,188	\$ 112,847	\$ 112,847
Investment securities available for sale	213,556	213,556	137,032	137,032
Federal Reserve Bank and Federal Home Loan Bank stock	2,882	2,882	2,862	2,862
Loans held for sale-mortgage banking	20,141	20,141	29,116	29,116
Participating interests in mortgage loans	1,705	1,705	4,888	4,888
Loans and leases held for investment, net	309,537	308,346	335,736	334,413
Other loans held for sale, net	-	-	70,501	70,501
Accrued interest receivable	2,118	2,118	2,138	2,138
	<u>636,127</u>	<u>\$ 634,936</u>	<u>695,120</u>	<u>\$ 693,797</u>
Other assets	47,519		49,180	
Other assets held for sale	-		2,769	
	<u>\$ 683,646</u>		<u>\$ 747,069</u>	
<b>Liabilities and Stockholders' Equity:</b>				
Deposits, noninterest-bearing	\$ 123,774	\$ 123,774	\$ 91,478	\$ 91,478
Deposits, interest-bearing	478,869	478,051	462,187	461,944
Deposits, non-interest-bearing held for sale	-	-	34,610	34,610
Deposits, interest-bearing held for sale	-	-	72,836	72,836
Borrowings and advances	13,684	13,684	16,329	16,329
Accrued interest payable	867	867	852	852
Accrued expenses	3,936	3,936	4,704	4,704
Guaranteed preferred beneficial interests in Company's subordinated debentures	24,466	11,602	24,134	11,356
	<u>645,596</u>	<u>\$ 631,914</u>	<u>707,130</u>	<u>\$ 694,109</u>
Other liabilities	2,644		2,618	
Stockholders' equity	35,406		37,321	
	<u>\$ 683,646</u>		<u>\$ 747,069</u>	
<b>Financial instruments with off-balance-sheet</b>				
Commitments to extend credit		\$ 26		\$ 31
Standby and commercial letters of credit		25		37
Mortgage banking commitments to fund		1,351		488
Mortgage banking commitments to sell		1,860		470
		<u>\$ 3,262</u>		<u>\$ 1,026</u>

## **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

For purposes of Items 2 and 3 of this report, we refer to (we), (our) or (the Company) when such reference includes BNCCORP, INC. and its consolidated subsidiaries, collectively; (BNCCORP) when referring only to BNCCORP, INC.; (the Bank) when referring only to BNC National Bank.

### **Comparison of Results for the Three Months Ended March 31, 2011 and 2010**

#### **Summary for the Three Months Ended March 31, 2011 and 2010**

Net income was \$573 thousand, and the net income available to common shareholders was \$234 thousand, or \$0.07 per share on a diluted basis, for the quarter ended March 31, 2011, compared to a net income of \$2.190 million or \$0.57 per diluted share, in the first quarter of 2010.

Net interest income for the first quarter of 2011 was \$5.160 million, a decrease of \$1.178 million, or 18.6%, from \$6.338 million in the same period of 2010. The net interest margin for the current period decreased to 3.09% from 3.42%.

In the first quarter of 2011 and 2010, the Company's provision for credit losses was \$600 thousand and \$2.000 million, respectively.

Non-interest income for the first quarter of 2011 was \$4.036 million. This compares to non-interest income of \$6.286 million for the same period in 2010, a decrease of \$2.250 million, or 35.8%.

Non-interest expense for the first quarter of 2011 was \$8.023 million compared to \$8.482 million in the same period of 2010, a decrease of \$459 thousand, or 5.4%.

No tax expense was recognized in the first quarter of 2011. The Company has net operating losses for federal and state purposes that reduce the Company's exposure to incurring a current tax liability. The Company believes it does not have a current income tax liability. In addition the Company is carrying a valuation allowance against its deferred tax assets. A tax benefit of \$48 thousand, or 2.2% of pre-tax income, was recognized in the first quarter of 2010.

## Net Interest Income

The following table presents average balance sheet information, yields on interest-earning assets and costs on interest-bearing liabilities (dollars are in thousands):

	Three Months Ended March 31,								
	2011			2010			Change		
	Average balance	Interest earned or owed	Average yield or cost	Average balance	Interest earned or owed	Average yield or cost	Average balance	Interest earned or owed	Average yield or cost
<b>Interest-earning assets</b>									
Federal funds sold/cash equivalents	\$ 134,818	\$ 79	0.24%	\$ 43,346	\$ 28	0.26%	\$ 91,472	\$ 51	-0.02%(a)
Investments - taxable	162,518	1,744	4.35%	198,345	2,705	5.53%	(35,827)	(961)	-1.18%(b)
Investments - tax exempt	2,114	24	4.60%	2,069	23	4.51%	45	1	0.09%
Loans held for sale – mortgage banking	15,649	185	4.79%	16,159	197	4.94%	(510)	(12)	-0.15%(c)
Participating interests in mortgage loans	1,898	20	4.27%	33,737	399	4.80%	(31,839)	(379)	-0.53%(d)
Loans and leases held for investment	394,453	4,855	4.99%	510,691	5,937	4.71%	(116,238)	(1,082)	0.28%(e)
Allowance for loan losses	(15,983)	-		(17,595)	-		1,612	-	
Total interest-earning assets	<u>\$ 695,467</u>	<u>\$ 6,907</u>	4.03%	<u>\$ 786,752</u>	<u>\$ 9,289</u>	4.79%	<u>\$ (91,285)</u>	<u>\$ (2,382)</u>	-0.76%
<b>Interest-bearing liabilities</b>									
Interest checking and money market accounts	\$ 268,268	\$ 327	0.49%	\$ 274,656	\$ 501	0.74%	\$ (6,388)	\$ (174)	-0.25%
Savings	12,887	3	0.09%	10,631	3	0.11%	2,256	-	-0.02%
Certificates of deposit under \$100,000	193,118	874	1.84%	296,992	1,761	2.40%	(103,874)	(887)	-0.56%(f)
Certificates of deposit \$100,000 and over	44,001	176	1.62%	49,592	271	2.22%	(5,591)	(95)	-0.60%(f)
Total interest-bearing deposits	518,274	1,380	1.08%	631,871	2,536	1.63%	(113,597)	(1,156)	-0.55%
Short-term borrowings	18,087	35	0.78%	9,111	16	0.71%	8,976	19	0.07%(g)
Federal Home Loan Bank advances	1	-	0.00%	11,453	113	4.00%	(11,452)	(113)	-4.00%(h)
Other borrowings	-	-	0.00%	26	-	0.00%	(26)	-	0.00%
Subordinated debentures	24,282	332	5.55%	23,036	286	5.04%	1,246	46	0.51%
Total borrowings	42,370	367	3.51%	43,626	415	3.86%	(1,256)	(48)	-0.35%
Total interest-bearing liabilities	<u>\$ 560,644</u>	<u>1,747</u>	1.26%	<u>\$ 675,497</u>	<u>2,951</u>	1.77%	<u>\$ (114,853)</u>	<u>(1,204)</u>	-0.51%
Net interest income/spread		<u>\$ 5,160</u>	2.77%		<u>\$ 6,338</u>	3.02%		<u>\$ (1,178)</u>	-0.25%
Net interest margin			3.01%			3.27%			-0.26%
Notation:									
Non-interest-bearing deposits	<u>\$ 153,468</u>	-	-	<u>\$ 105,821</u>	-		<u>\$ 47,646</u>	-	
Total deposits	<u>\$ 671,742</u>	<u>\$ 1,380</u>	0.83%	<u>\$ 737,692</u>	<u>\$ 2,536</u>	1.39%	<u>\$ (65,951)</u>	<u>\$ (1,156)</u>	-0.56%
Taxable equivalents:									
Total interest-earning assets	\$ 695,467	\$ 6,922	4.04%	\$ 786,752	\$ 9,304	4.80%	\$ (91,285)	\$ (2,382)	-0.76%
Net interest income/spread	-	\$ 5,175	2.78%	-	\$ 6,353	3.03%	-	\$ (1,178)	-0.25%
Net interest margin	-	-	3.02%	-	-	3.27%	-	-	-0.25%

Overall, interest rates on assets and liabilities have declined due to the general decline of interest rates.

- We elected to remain very liquid in 2010 and 2011 until the branch divestiture was completed.
- Taxable investments decreased throughout 2010 and early 2011 due to sales and repayments. Since the divestiture we have been deploying cash into investments.
- The balance of loans held for sale can vary depending on the volume of loans originated and efficiency with which the loans are sold.
- See Note 4 to the quarterly report for explanation of decrease.
- The balance of loans has declined due to repayments, sales and charge-offs.
- In 2010 and early 2011 the balances of certificates have declined as we have been focusing on reducing the cost of funds.
- Short term borrowings will vary depending on our customers need to use repurchase agreements.
- The average balance of FHLB advances decreased because we have been able to fund more of our assets with deposits.

## Non-interest Income

The following table presents the major categories of our non-interest income (dollars are in thousands):

	Three Months Ended			
	March 31,		Increase (Decrease)	
	2011	2010	\$	%
Bank charges and service fees	\$ 560	\$ 617	\$ (57)	(9) %
Wealth management revenues	385	571	(186)	(33) % (a)
Mortgage banking revenues, net	2,063	2,185	(122)	(6) % (b)
Gains (losses) on sales of loans, net	488	(2)	490	N/M % (c)
Gains on sales of securities, net	361	2,505	(2,144)	(86) % (c)
Other	179	410	(231)	(56) % (d)
Total non-interest income	<u>\$ 4,036</u>	<u>6,286</u>	<u>(2,250)</u>	<u>(36) %</u>

- (a) Wealth management revenues are expected to decrease in 2011 as we have exited the ESOP trustee business and the custodial service for insurance products sold by third parties.
- (b) The housing industry is currently experiencing challenges and the ability to generate mortgage banking revenues will be impacted by the industry's recovery, interest rates and governmental influences.
- (c) Gains and losses on sales will vary significantly from period to period. Gains on sales of loans are likely to be higher in 2011 as we plan to continue selling the guaranteed portion of certain SBA loans we originate.
- (d) In early 2010 we sold a branch at a gain of \$403 thousand.

## Non-interest Expense

The following table presents the major categories of our non-interest expense (dollars are in thousands):

	Three Months Ended			
	March 31,		Increase (Decrease)	
	2011	2010	\$	%
Salaries and employee benefits	\$ 4,013	\$ 4,100	\$ (87)	(2) %
Professional services	737	765	(28)	(4) % (a)
Data processing fees	685	602	83	14 %
Occupancy	586	731	(145)	(20) % (b)
Regulatory costs	516	385	131	34 % (c)
Other real estate costs	321	454	(133)	(29) % (d)
Marketing and promotion	314	330	(16)	(5) %
Depreciation and amortization	297	331	(34)	(10) %
Office supplies and postage	145	150	(5)	(3) %
Other	409	634	(225)	(35) % (e)
Total non-interest expense	<u>\$ 8,023</u>	<u>\$ 8,482</u>	<u>(459)</u>	<u>(5) %</u>
Efficiency ratio	<u>87.2%</u>	<u>67.2%</u>		

- (a) Professional services costs will be impacted by mortgage banking activities and legal/investigative costs related to the fraud loss on assets serviced by others.
- (b) Occupancy costs have declined as we have closed and relocated branches to reduce costs.
- (c) Regulatory costs have generally been increasing for financial institutions.
- (d) Other real estate costs are lower as it has not been necessary to reduce carrying values of foreclosed properties.
- (e) In 2010, we incurred costs for a branch closure of \$105 thousand.

## Income Taxes

No tax expense was recognized in the first quarter of 2011. The Company has net operating losses for federal and state purposes that reduce the Company's exposure to incurring a current tax liability. The Company believes it does not have a current income tax liability. In addition the Company is carrying a valuation allowance against its deferred tax assets. A tax benefit of \$48 thousand, or 2.2% of the pre-tax income, was recognized in the first quarter of 2010.

## Comparison of Financial Condition at March 31, 2011 and December 31, 2010

### Assets

The following table presents our assets by category (dollars are in thousands):

	March 31,	December 31,	Increase (Decrease)		
	2011	2010	\$	%	
Cash and cash equivalents	\$ 86,188	\$ 112,847	\$ (26,659)	(24)	% (a)
Investment securities available for sale	213,556	137,032	76,524	56	% (b)
Federal Reserve Bank and Federal Home Loan Bank of Des Moines stock	2,882	2,862	20	1	%
Loans held for sale-mortgage banking	20,141	29,116	(8,975)	(31)	% (c)
Participating interests in mortgage loans	1,705	4,888	(3,183)	(65)	%
Loans and leases held for investment, net	309,537	335,736	(26,199)	(8)	% (d)
Other loans held for sale	-	70,501	(70,501)	(100)	% (e)
Other real estate, net	12,506	12,706	(200)	(2)	
Premises and equipment, net	16,510	16,684	(174)	(1)	
Interest receivable	2,118	2,138	(20)	(1)	%
Other assets	18,503	19,790	(1,287)	(7)	%
Premises and equipment held for sale, net	-	2,769	(2,769)	(100)	% (e)
Total assets	<u>\$ 683,646</u>	<u>\$ 747,069</u>	<u>\$ (63,423)</u>	(8)	%

- (a) Cash balances have decreased as funds were invested elsewhere or used to finance the branch divestiture.
- (b) Investments have increased as we have deployed liquidity.
- (c) The balance of loans held for sale can vary depending on the volume of loans originated and efficiency with which the loans are sold.
- (d) The balance of loans has declined due to repayments, sales and charge-offs.
- (e) These balances decreased when our divestiture was consummated.

## Loans and Leases Held For Investment Portfolio

The following table presents the composition of our loans and leases held for investment portfolio as of the dates indicated (dollars are in thousands):

	March 31, 2011		December 31, 2010		Increase (Decrease)	
	Amount	%	Amount	%	Amount	%
Commercial and industrial	\$ 75,959	24.4	\$ 76,617	22.5	\$ (658)	(1) %
Real estate mortgage	192,889	62.0	211,852	62.2	(18,963)	(9) % (a)
Real estate construction	37,405	12.0	40,986	12.0	(3,581)	(9) % (a)
Participating interests in mortgage loans	1,705	0.5	4,888	1.4	(3,183)	(65) % (b)
Agricultural	11,884	3.8	15,114	4.4	(3,230)	(21) %
Other	5,772	1.9	6,229	1.8	(457)	(7) %
Total principal amount of loans	325,614	104.6	355,686	104.4	(30,072)	(8) %
Unearned income and net unamortized deferred fees and costs	(196)	(0.1)	(297)	(0.1)	101	(34) %
Loans, net of unearned income and unamortized fees and costs	325,418	104.5	355,389	104.3	(29,971)	(8) % (a)
Less allowance for credit losses	(14,176)	(4.5)	(14,765)	(4.3)	589	(4) % (c)
Net loans	\$ 311,242	100.0	\$ 340,624	100.0	\$ (29,382)	(9) %

- (a) On an overall basis loans have decreased due to repayments. Construction loans decreased because construction projects have been completed and reclassified to real estate mortgage loans.
- (b) See Note 4 to the quarterly report.
- (c) See allowance for credit losses section of this document.

## Loan Participations

Pursuant to our lending policy, loans may not exceed 85 percent of the Bank's legal lending limit (except to the extent collateralized by U.S. Treasury securities or Bank deposits) unless the Bank's Chief Credit Officer or the Executive Credit Committee grant prior approval. To accommodate customers whose financing needs exceed lending limits and internal restrictions, the Bank sells loan participations to outside participants without recourse.

The sales of participations are accounted for pursuant to FASB ASC 860, *Transfers and Servicing*.

Loan participations sold on a nonrecourse basis to outside financial institutions were \$249.6 million as of March 31, 2011 and \$259.9 million as of December 31, 2010.

## Concentrations of Credit

The following table summarizes the locations and current balances of our borrowers (in thousands):

	March 31, 2011			December 31, 2010		
	Amount	%		Amount	%	
North Dakota	\$ 152,145	47 %		\$ 170,582	48 %	
Minnesota	88,890	27		90,255	25	
Arizona	32,366	10		40,818	12	
Other	52,213	16		54,031	15	
Totals	\$ 325,614	100 %		\$ 355,686	100 %	

Our borrowers use loan proceeds for projects in various geographic areas. The following table summarizes the locations and current balances where our borrowers are using loan proceeds (in thousands):

	<b>March 31, 2011</b>			<b>December 31, 2010</b>		
North Dakota	\$	149,231	46 %	\$	162,364	46 %
Arizona		45,684	14		51,631	14
Texas		26,744	8		26,761	7
Minnesota		26,033	8		27,448	8
California		24,053	7		31,696	9
Kentucky		10,656	3		10,717	3
Idaho		8,962	3		9,095	3
Wisconsin		6,930	2		7,000	2
Colorado		5,755	2		6,333	2
Other		21,566	7		22,641	6
Totals	\$	<u>325,614</u>	<u>100 %</u>	\$	<u>355,686</u>	<u>100 %</u>

The following table presents loans by type within our three primary states (in thousands):

	<b>March 31, 2011</b>		<b>December 31, 2010</b>	
North Dakota				
Commercial and industrial	\$	73,401	\$	80,536
Construction		977		1,029
Agricultural		11,170		13,673
Land and land development		10,602		10,682
Owner-occupied commercial real estate		24,309		24,941
Non-owner-occupied commercial real estate		12,276		12,567
Small business administration		2,581		3,116
Consumer/participating interests		13,915		15,820
Subtotal	\$	<u>149,231</u>	\$	<u>162,364</u>
Arizona				
Commercial and industrial	\$	2,961	\$	606
Construction		-		-
Agricultural		-		-
Land and land development		8,514		8,621
Owner-occupied commercial real estate		-		814
Non-owner-occupied commercial real estate		22,120		26,797
Small business administration		7,405		7,446
Consumer/participating interests		4,684		7,347
Subtotal	\$	<u>45,684</u>	\$	<u>51,631</u>
Minnesota				
Commercial and industrial	\$	857	\$	627
Construction		2,082		2,002
Agricultural		31		30
Land and land development		4,526		4,600
Owner-occupied commercial real estate		1,015		736
Non-owner-occupied commercial real estate		16,645		17,422
Small business administration		186		58
Consumer/participating interests		691		1,973
Subtotal	\$	<u>26,033</u>	\$	<u>27,448</u>

The overall decline in balances can primarily be attributed to the divestiture. See Note 5 to the quarterly report.

## Loan Maturities (1)

The following table sets forth the remaining maturities of loans in each major category of our portfolio as of March 31, 2011 (in thousands):

	One year or less	Over 1 year through 5 years		Over 5 years		Total
		Fixed Rate	Floating Rate	Fixed Rate	Floating rate	
Commercial and industrial	\$ 34,009	\$ 25,646	\$ 1,842	\$ 7,291	\$ 7,171	\$ 75,959
Real estate mortgage	50,403	60,824	42,824	18,135	20,703	192,889
Real estate construction	19,591	8,488	4,828	519	3,979	37,405
Participating interests in mortgage loans	1,705	-	-	-	-	1,705
Agricultural	3,041	6,106	608	507	1,622	11,884
Other	1,883	2,791	411	152	535	5,772
<b>Total principal amount of loans</b>	<b>\$ 110,632</b>	<b>\$ 103,855</b>	<b>\$ 50,513</b>	<b>\$ 26,604</b>	<b>\$ 34,010</b>	<b>\$ 325,614</b>

- (1) Maturities are based on contractual maturities. Floating rate loans include loans that would reprice prior to maturity if base rates change.

Actual maturities may differ from the contractual maturities shown above as a result of renewals and prepayments. Loan renewals are evaluated in the same manner as new credit applications.

## Allowance for Credit Losses

The following table sets forth information regarding changes in our allowance for credit losses (dollars are in thousands):

	Three Months Ended	
	March 31,	
	2011	2010
<b>Balance, beginning of period</b>	\$ 16,476	\$ 18,047
Provision for credit losses	600	2,000
Loans charged off	(1,299)	(1,881)
Loans recovered	30	29
Transferred with branch divestiture	(1,631)	-
<b>Balance, end of period</b>	<b>\$ 14,176</b>	<b>\$ 18,195</b>
Total loans	<u>\$ 345,559</u>	<u>\$ 561,072</u>
Loans and leases held for investment	<u>\$ 323,713</u>	<u>\$ 504,578</u>
Allowance for credit losses as a percentage of total loans	4.10%	3.24%
Allowance for credit losses as a percentage of loans and leases held for investment	4.38%	3.61%

	<b>Three Months Ended March 31,</b>	
	<b>2011</b>	<b>2010</b>
Ratio of net charge-offs to average total loans	(0.308)%	(0.330)%
Ratio of net charge-offs to average loans and leases held for investment	(0.322)%	(0.363)%
Ratio of net charge-offs to average total loans, annualized	(1.232)%	(1.321)%
Ratio of net charge-offs to average loans and leases held for investment, annualized	(1.287)%	(1.451)%

The provision for credit losses was \$600 thousand in the first quarter of 2011 and \$2.000 million in the first quarter of 2010.

The following table summarizes activity and other information related to the allowance for credit losses as of March 31 (in thousands):

	<b>2011</b>	<b>2010</b>
Balance of allowance for credit losses, beginning of period	\$ 16,476	\$ 18,047
<b>Charge-offs:</b>		
Commercial and industrial	-	(82)
Real estate mortgage	(1,298)	(201)
Real estate construction	-	(1,596)
Agricultural	-	-
Other	(1)	(2)
Total charge-offs	(1,299)	(1,881)
<b>Recoveries:</b>		
Commercial and industrial	1	14
Real estate mortgage	-	-
Real estate construction	13	9
Agricultural	-	-
Other	16	6
Total recoveries	30	29
Net charge-offs	(1,269)	(1,852)
Provision for credit losses charged to operations	600	2,000
Transferred with branch divestiture	(1,631)	-
Balance of allowance for credit losses, end of period	\$ 14,176	\$ 18,195
Ratio of net charge-offs to average total loans	(0.308)%	(0.330)%
Ratio of net charge-offs to average loans and leases held for investment	(0.322)%	(0.363)%
Average gross loans and leases held for investment	\$ 394,453	\$ 510,692
Ratio of allowance for credit losses to loans and leases held for investment	4.38%	3.61%
Ratio of allowance for credit losses to nonperforming loans	71%	54%

The ratio of allowance for credit losses to total loans has increased to reflect the depressed economic conditions, the amount and trend of nonperforming loans, declines in collateral values and other factors that influence management's ongoing evaluation of the loan portfolio.

The table below presents, for the periods indicated an allocation of the allowance for credit losses among the various loan categories and sets forth the percentage of loans in each category to gross loans. The allocation of the allowance for credit losses as shown in the table should neither be interpreted as an indication of future charge-offs, nor as an indication that charge-offs in future periods will necessarily occur in these amounts or in the indicated proportions.

### Allocation of the Allowance for Loan Losses

	March 31, 2010		December 31, 2010	
	Amount of allowance	Loans in category as a percentage of total gross loans	Amount of allowance	Loans in category as a percentage of total gross loans
Commercial and industrial	\$ 1,458	23%	\$ 1,078	22%
Real estate mortgage	9,354	59%	11,406	60%
Real estate construction	3,153	11%	1,995	11%
Participating interests in mortgage loans	4	1%	14	1%
Agricultural	131	4%	174	4%
Other	76	2%	98	2%
Total	<u>\$ 14,176</u>	<u>100%</u>	<u>\$ 14,765</u>	<u>100%</u>

We do not originate sub-prime single family loans. We do have a significant portion of our portfolio in construction and commercial real estate. While the Company believes these loans are adequately secured, there has been a significant slow down in the construction and commercial real estate market. We continue to closely monitor all loans, but particularly those in deteriorating industries.

### Nonperforming Loans

The following table sets forth information concerning our nonperforming loans as of the dates indicated (dollars are in thousands):

	Three Months Ended March 31,	
	2011	2010
Balance, beginning of period	\$ 17,862	\$ 35,890
Additions to nonperforming	6,179	1,045
Charge-offs	(1,292)	(1,819)
Reclassified back to performing	-	-
Principal payments received	(2,900)	(1,264)
Transferred to other real estate owned	-	-
Balance, end of period	<u>\$ 19,849</u>	<u>\$ 33,852</u>

## Nonperforming Assets

The following table sets forth information concerning our nonperforming assets as of the dates indicated (dollars are in thousands):

	<u>March 31,</u> <u>2011</u>	<u>December 31,</u> <u>2010</u>
<b>Nonperforming loans:</b>		
Loans 90 days or more delinquent and still accruing interest	\$ 370	\$ -
Non-accrual loans	19,479	17,862
<b>Total nonperforming loans</b>	<u>19,849</u>	<u>17,862</u>
Other real estate, net	12,506	12,706
<b>Total nonperforming assets</b>	<u>\$ 32,355</u>	<u>\$ 30,568</u>
Allowance for credit losses	<u>\$ 14,176</u>	<u>\$ 14,765</u>
Ratio of total nonperforming loans to total loans	5.74%	3.93%
Ratio of total nonperforming loans to loans and leases held for investment	6.13%	5.10%
Ratio of total nonperforming assets to total assets	4.73%	4.09%
Ratio of allowance for credit losses to total nonperforming loans	71%	83%

**Loans 90 days or more delinquent and still accruing interest** include loans over 90 days past due which we believe, based on our specific analysis of the loans, do not present doubt about the collection of interest and principal in accordance with the loan contract. Loans in this category must be well-secured and in the process of collection.

### Non-accrual loans

Non-accrual loans include loans on which the accrual of interest has been discontinued. Accrual of interest is discontinued when we believe, after considering economic and business conditions and collection efforts that the borrower's financial condition is such that the collection of interest is doubtful. A delinquent loan is generally placed on non-accrual status when it becomes 90 days or more past due unless the loan is well-secured and in the process of collection. When a loan is placed on non-accrual status, accrued but uncollected interest income applicable to the current reporting period is reversed against interest income of the current period. Accrued but uncollected interest income applicable to previous reporting periods is charged against the allowance for credit losses. No additional interest is accrued on the loan balance until the collection of both principal and interest becomes reasonably certain. When problem loans are restructured or resolved otherwise, there may be additional write-downs or charge-offs of principal. These events may necessitate additional charges to earnings.

At March 31, 2011 the Bank had \$43.3 million of classified loans and \$19.5 million of loans on non-accrual. This compares to \$47.6 million of classified loans and \$17.9 million of loans on non-accrual at December 31, 2010.

The following table indicates the effect on income if interest on non-accrual and restructured loans outstanding at period end had been recognized at original contractual rates (in thousands):

	<b>Three Months Ended March 31,</b>	
	<b>2011</b>	<b>2010</b>
Interest income that would have been recorded	\$ 404	\$ 402
Interest income recorded	132	-
Effect on interest income	<u>\$ 272</u>	<u>\$ 402</u>

### Impaired Loans

Impaired loans generally include loans which management believes it is probable that the Bank will not be able to collect all amounts due in accordance with the terms of the loan agreement and which are analyzed for a specific reserve allowance. The Bank generally considers loans risk-graded substandard and doubtful, as well as non-accrual and certain restructured loans, as impaired loans.

As of the dates indicated below, the Bank's recorded investment in impaired loans and the related valuation allowance was as follows (in thousands):

	<b>March 31, 2011</b>		<b>December 31, 2010</b>	
	<b>Recorded Investment</b>	<b>Valuation Allowance</b>	<b>Recorded Investment</b>	<b>Valuation Allowance</b>
Valuation allowance required	\$ 19,326	\$ 3,330	\$ 17,819	\$ 2,710
No valuation allowance required	568	-	43	-
Total impaired loans	<u>\$ 19,894</u>	<u>\$ 3,330</u>	<u>\$ 17,862</u>	<u>\$ 2,710</u>

The valuation allowance on impaired loans is included in the Bank's allowance for credit losses. The average recorded investment in impaired loans as of the dates indicated, and approximate interest income recognized for such loans for the periods indicated, were as follows (dollars are in thousands):

	<b>March 31, 2011</b>	<b>March 31, 2010</b>
	Average recorded investment in impaired loans	\$ 20,284
Average recorded investment in impaired loans as a percentage of average total loans	<u>4.92%</u>	<u>6.36%</u>
	<b>Three Months Ended March 31, 2011</b>	<b>Three Months Ended March 31, 2010</b>
Interest income recognized on impaired loans	\$ 5	\$ -
Interest income recognized on a cash basis during the time of impairment	<u>\$ -</u>	<u>\$ -</u>

Cash receipts on impaired loans that are on non-accrual are applied to principal. Cash receipts on restructured loans included in impaired loans are recognized in accordance with the restructured terms. Interest income on impaired loans is recognized on an accrual basis only when the loan is considered to be well collateralized and payments are being received as we currently expect even though expectations are other than the original contractual terms.

## Restructured Loans

Restructured loans are loans for which concessions, including a reduced interest rate or a deferral of interest or principal, have been granted due to the borrower's weakened financial condition. Once a loan is restructured, interest is accrued at the restructured rates when no loss of principal is anticipated. A loan that has performed in accordance with restructured terms for one year is no longer reported as a restructured loan. We had restructured loans aggregating \$31.6 million at March 31, 2011 and \$34.3 million at December 31, 2010.

## Potential Problem Loans

We attempt to quantify potential problem loans with more immediate exposure and at March 31, 2011 such loans totaled \$8.7 million compared to \$12.4 million at December 31, 2010. A significant portion of these potential problem loans are not in default but may have characteristics such as recent adverse operating cash flows or general risk characteristics that the loan officer feels might jeopardize the future timely collection of principal and interest payments. The ultimate resolution of these credits is subject to changes in economic conditions and other factors. These loans are closely monitored to ensure that our position as creditor is protected to the fullest extent possible.

## Other Real Estate

See Note 6 included in the quarterly report.

## Liabilities

The following table presents our liabilities (dollars are in thousands):

Liabilities	March 31,	December 31,	Increase (Decrease)	
	2011	2010	\$	%
Deposits:				
Non-interest-bearing	\$ 123,774	\$ 91,478	\$ 32,296	35 % (a)
Interest-bearing-				
Savings, interest checking and money market	253,831	243,332	10,499	4 % (a)
Time deposits \$100,000 and over	77,506	39,580	1,462	4 %
Time deposits under \$100,000	147,532	179,275	4,721	3
Non-interest-bearing held for sale	-	34,610	(34,610)	(100) (b)
Interest-bearing held for sale	-	72,836	(72,836)	(100) % (b)
Short-term borrowings	13,684	16,329	(2,645)	(16) %
FHLB advances	-	-	-	- %
Other borrowings	-	-	-	- %
Guaranteed preferred beneficial interests in Company's subordinated debentures	24,466	24,134	332	1 %
Accrued interest payable	867	852	15	2 %
Accrued expenses	3,936	4,704	(768)	(16) %
Other liabilities	2,644	2,618	26	1 %
Total liabilities	\$ 648,240	\$ 709,748	\$ (61,508)	(9) %

(a) We have emphasized deposit growth and marketing initiatives focused on lower cost deposits. Balances have increased due to success in these strategies. These types of accounts can fluctuate significantly due to the cash management activities of our customers, particularly our commercial customers.

(b) These balances decreased when the branch divestiture was consummated.

## **Stockholders' Equity**

Our stockholders' equity decreased \$1.9 million between December 31, 2010 and March 31, 2011 primarily due to changes in unrealized gains and losses in our investment portfolio.

## **Liquidity Risk Management**

Liquidity risk is the possibility of being unable to meet all present and future financial obligations in a timely manner. Liquidity risk management encompasses our ability to meet all present and future financial obligations in a timely manner. The objectives of liquidity management policies are to maintain adequate liquid assets, liability diversification among instruments, maturities and customers and a presence in both the wholesale purchased funds market and the retail deposit market.

The Consolidated Statements of Cash Flows in the Consolidated Financial Statements present data on cash and cash equivalents provided by and used in operating, investing and financing activities. In addition to liquidity from core deposit growth, together with repayments and maturities of loans and investments, we utilize brokered deposits, sell securities under agreements to repurchase and borrow overnight Federal funds. The Bank is a member of the FHLB of Des Moines. Advances from the FHLB are collateralized by the Bank's mortgage loans and various investment securities. We have also obtained funding through the issuance of subordinated notes, subordinated debentures and long-term borrowings.

Our liquidity is measured by our ability to raise cash when we need it at a reasonable cost and with a minimum of losses. Given the uncertain nature of our customers' demands as well as our desire to take advantage of earnings enhancement opportunities, we must have adequate sources of on- and off-balance-sheet funds that can be acquired in time of need.

We measure our liquidity position on an ongoing basis. Key factors that determine our liquidity are the reliability or stability of our deposit base, the pledged/non-pledged status of our investments and potential loan demand. Our liquidity management system divides the balance sheet into liquid assets and short-term liabilities that are assumed to be vulnerable to non-replacement under abnormally stringent conditions. The excess of liquid assets over short-term liabilities is measured over a 30-day planning horizon. Assumptions for short-term liabilities vulnerable to non-replacement under abnormally stringent conditions are based on a historical analysis of the month-to-month percentage changes in deposits. The excess of liquid assets over short-term liabilities and other key factors such as expected loan demand as well as access to other sources of liquidity such as lines with the FHLB, Federal funds and those other supplemental sources listed above are tied together to provide a measure of our liquidity. We have a targeted range and manage our operations such that these targets can be achieved. We believe that our prudent management policies and guidelines will ensure adequate levels of liquidity to fund anticipated needs of on- and off-balance-sheet items. In addition, a contingency funding policy statement identifies actions to be taken in response to an adverse liquidity event, and identifies potential funding needs and funding sources under various "stressed scenarios."

Available borrowing capacity from the FHLB was approximately \$51.7 million as of March 31, 2011.

### Item 3. Quantitative and Qualitative Disclosures about Market Risk

Market risk arises from changes in interest rates, exchange rates, and commodity prices and equity prices and represents the possibility that changes in future market rates or prices will have a negative impact on our earnings or value. Our principal market risk is interest rate risk.

Interest rate risk arises from changes in interest rates. Interest rate risk can result from: (1) Repricing risk – timing differences in the maturity/repricing of assets, liabilities, and off-balance-sheet contracts; (2) Options risk – the effect of embedded options, such as loan prepayments, interest rate caps/floors, and deposit withdrawals; (3) Basis risk – risk resulting from unexpected changes in the spread between two or more different rates of similar maturity, and the resulting impact on the behavior of lending and funding rates; and (4) Yield curve risk – risk resulting from unexpected changes in the spread between two or more rates of different maturities from the same type of instrument. We have risk management policies to monitor and limit exposure to interest rate risk. To date we have not conducted trading activities as a means of managing interest rate risk. Our asset/liability management process is utilized to manage our interest rate risk. The measurement of interest rate risk associated with financial instruments is meaningful only when all related and offsetting on- and off-balance-sheet transactions are aggregated, and the resulting net positions are identified.

Our interest rate risk exposure is actively managed with the objective of managing the level and potential volatility of net interest income in addition to the long-term growth of equity, bearing in mind that we will always be in the business of taking on rate risk and that rate risk immunization is not entirely possible. Also, it is recognized that as exposure to interest rate risk is reduced, so too may the overall level of net interest income and equity. In general, the assets and liabilities generated through ordinary business activities do not naturally create offsetting positions with respect to repricing or maturity characteristics. Access to the derivatives market can be an important element in maintaining our interest rate risk position within policy guidelines. Using derivative instruments, principally interest rate floors, caps, and interest rate swaps, the interest rate sensitivity of specific transactions, as well as pools of assets or liabilities, can be adjusted to maintain the desired interest rate risk profile.

Our primary tool for measuring and managing interest rate risk is net interest income simulation. This exercise includes our assumptions regarding the changes in interest rates and the impact on our current balance sheet. Interest rate caps and floors are included to the extent that they are exercised in the 12-month simulation period. Additionally, changes in prepayment behavior of the residential mortgage, CMOs, and mortgage-backed securities portfolios in each rate environment are captured using industry estimates of prepayment speeds for various coupon segments of the portfolio. For purposes of this simulation, projected month end balances of the various balance sheet accounts are held constant at their March 31, 2011 levels. Cash flows from a given account are reinvested back into the same account so as to keep the month end balance constant at its March 31, 2011 level. The static balance sheet assumption is made so as to project the interest rate risk to net interest income embedded in the existing balance sheet. With knowledge of the balance sheet's existing net interest income profile, more informed strategies and tactics may be developed as it relates to the structure/mix of growth.

We monitor the results of net interest income simulation on a regular basis. Net interest income is generally simulated for the upcoming 12-month horizon in seven interest rate scenarios. The scenarios generally modeled are parallel interest rate ramps of +/- 100bp, 200bp, and 300bp along with a rates unchanged scenario. Given the current low absolute level of interest rates as of March 31, 2011, the downward scenarios for interest rate movements is limited to -100bp but a +400bp scenario has been added. The parallel movement of interest rates means all projected market interest rates move up or down by the same amount. A ramp in interest rates means that the projected change in market interest rates occurs over the 12-month horizon on a pro-rata basis. For example, in the +100bp scenario, the projected Prime rate is projected to increase from 3.25% to 4.25% 12 months later. The Prime rate in this example will increase 1/12th of the overall increase of 100 basis points each month.

The net interest income simulation results for the 12-month horizon are shown below (dollars are in thousands):

<b>Net Interest Income Simulation</b>						
Movement in interest rates	<u>-100bp</u>	<u>Unchanged</u>	<u>+100bp</u>	<u>+200bp</u>	<u>+300bp</u>	<u>+400bp</u>
Projected 12-month net interest income	\$ 18,521	\$ 19,916	\$ 20,334	\$ 20,412	\$ 20,356	\$ 20,211
Dollar change from unchanged scenario	\$ (1,395)	-	\$ 418	\$ 496	\$ 440	\$ 295
Percentage change from unchanged scenario	(7.00)%	-	2.10%	2.49%	2.21%	1.48%

Since there are limitations inherent in any methodology used to estimate the exposure to changes in market interest rates, these analyses are not intended to be a forecast of the actual effect of changes in market interest rates such as those indicated above on the Company. Further, these analyses are based on our assets and liabilities as of March 31, 2011 (without forward adjustments for planned growth and anticipated business activities) and do not contemplate any actions we might undertake in response to changes in market interest rates.

Static gap analysis is another tool that may be used for interest rate risk measurement. The net differences between the amount of assets, liabilities, equity and off-balance-sheet instruments repricing within a cumulative calendar period is typically referred to as the “rate sensitivity position” or “gap position.” The following table sets forth our rate sensitivity position as of March 31, 2011. Assets and liabilities are classified by the earliest possible repricing date or maturity, whichever occurs first.

## Interest Sensitivity Gap Analysis

### Estimated maturity or repricing at March 31, 2011

	<u>0-3</u>	<u>4-12</u>	<u>1-5</u>	<u>Over</u>	<u>Total</u>
	<u>months</u>	<u>Months</u>	<u>Years</u>	<u>5 years</u>	
	(dollars are in thousands)				
<b>Interest-earning assets:</b>					
Interest-bearing deposits with banks	\$ 86,188	\$ -	\$ -	\$ -	\$ 86,188
Investment securities (a)	10,903	29,275	106,218	59,315	205,711
FRB and FHLB stock	2,882	-	-	-	2,882
Fed funds sold	-	-	-	-	-
Loans held for sale-mortgage banking, fixed rate	-	20,141	-	-	20,141
Loans held for sale-mortgage banking, floating rate	-	-	-	-	-
Loans held for investment, fixed rate	36,525	36,926	74,526	13,080	161,057
Loans held for investment, floating rate	148,863	1,799	13,699	-	164,361
Total interest-earning assets	<u>\$ 285,361</u>	<u>\$ 88,141</u>	<u>\$ 194,443</u>	<u>\$ 72,395</u>	<u>\$ 640,340</u>
<b>Interest-bearing liabilities:</b>					
Interest checking and money market accounts	\$ 240,933	\$ -	\$ -	\$ -	\$ 240,933
Savings	12,898	-	-	-	12,898
Time deposits under \$100,000	16,302	45,651	45,358	40,221	147,532
Time deposits \$100,000 and over	20,781	46,711	10,014	-	77,506
Short-term borrowings	13,684	-	-	-	13,684
FHLB advances	-	-	-	-	-
Other borrowing	-	-	-	-	-
Subordinated debentures	15,000	-	-	9,466	24,466
Total interest-bearing liabilities	<u>\$ 319,598</u>	<u>\$ 92,362</u>	<u>\$ 55,372</u>	<u>\$ 49,687</u>	<u>\$ 517,019</u>
Interest rate gap	<u>\$ (34,237)</u>	<u>\$ (4,221)</u>	<u>\$ 139,071</u>	<u>\$ 22,708</u>	<u>\$ 123,321</u>
Cumulative interest rate gap at March 31, 2011	<u>\$ (34,237)</u>	<u>\$ (38,458)</u>	<u>\$ 100,613</u>	<u>\$ 123,321</u>	
Cumulative interest rate gap to total assets	(5.01)%	(5.63)%	14.72%	18.04%	

(a) Cash flows from securities are less than the fair value amount on the balance sheet due to the securities net unamortized premiums of \$7.845 million.

The table assumes that all savings and interest-bearing demand deposits reprice in the earliest period presented, however, we believe a significant portion of these accounts constitute a core component and are generally not rate sensitive. Our position is supported by the fact that reductions in interest rates paid on these deposits historically have not caused notable reductions in balances in net interest income because the repricing of certain assets and liabilities is discretionary and is subject to competitive and other pressures. As a result, assets and liabilities indicated as repricing within the same period may in fact reprice at different times and at different rate levels.

Static gap analysis does not fully capture the impact of embedded options, lagged interest rate changes, administered interest rate products, or certain off-balance-sheet sensitivities to interest rate movements. Therefore, this tool generally cannot be used in isolation to determine the level of interest rate risk exposure in banking institutions.

Since there are limitations inherent in any methodology used to estimate the exposure to changes in market interest rates, these analyses are not intended to be a forecast of the actual effect of changes in market interest rates such as those indicated above on the Company. Further, these analyses are based on our assets and liabilities as of March 31, 2011 and do not contemplate any actions we might undertake in response to changes in market interest rates.

## **Other Information**

### **Item 1. Legal Proceedings**

From time to time, we may be a party to legal proceedings arising out of our lending, deposit operations or other activities. We engage in foreclosure proceedings and other collection actions as part of our loan collection activities. From time to time, borrowers may also bring actions against us, in some cases claiming damages. Some financial services companies have been subjected to significant exposure in connection with litigation, including class action litigation and punitive damage claims. While we are not aware of any such actions or allegations that should reasonably give rise to any material adverse effect, it is possible that we could be subjected to such a claim in an amount that could be material. Based upon a review with our legal counsel, we believe that the ultimate disposition of such pending litigation will not have a material effect on our financial condition, results of operations or cash flows.

We have asserted claims against our insurance carriers as described in Note 4.

## Signatures

This report is submitted on behalf of the Company by the duly authorized undersigned.

BNCCORP, INC.

Date: May 9, 2011

By: /s/ Gregory K. Cleveland  
Gregory K. Cleveland  
President and Chief Executive Officer

By: /s/ Timothy J. Franz  
Timothy J. Franz  
Chief Financial Officer