



BNCCORP

Quarterly Report

For the quarter ended September 30, 2010

BNCCORP, INC.

(Pink Sheets:BNCC)

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BNCCORP, INC.
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September 30, 2010

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FINANCIAL INFORMATION

Item 1. Financial Statements

BNCCORP, INC. AND SUBSIDIARIES

Consolidated Balance Sheets
(In thousands, except share data)

| ASSETS | September 30, 2010 | December 31, 2009 |
|--|-----------------------|----------------------|
| | (unaudited) | |
| CASH AND CASH EQUIVALENTS | \$ 48,496 | \$ 35,362 |
| INVESTMENT SECURITIES AVAILABLE FOR SALE | 150,322 | 212,661 |
| FEDERAL RESERVE BANK AND FEDERAL HOME LOAN BANK STOCK | 2,862 | 3,048 |
| LOANS HELD FOR SALE | 50,691 | 24,130 |
| PARTICIPATING INTERESTS IN MORTGAGE LOANS | 12,943 | 38,534 |
| LOANS AND LEASES HELD FOR INVESTMENT | 445,726 | 517,108 |
| ALLOWANCE FOR CREDIT LOSSES | (16,757) | (18,047) |
| Net loans and leases held for investment | 441,912 | 537,595 |
| OTHER REAL ESTATE, net | 10,571 | 7,253 |
| PREMISES AND EQUIPMENT, net | 19,519 | 20,422 |
| INTEREST RECEIVABLE | 2,342 | 2,970 |
| OTHER ASSETS | 22,276 | 24,642 |
| Total assets | <u>\$ 748,991</u> | <u>\$ 868,083</u> |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| DEPOSITS: | | |
| Non-interest-bearing | \$ 114,050 | \$ 98,658 |
| Interest-bearing – | | |
| Savings, interest checking and money market | 290,711 | 280,571 |
| Time deposits \$100,000 and over | 43,391 | 52,222 |
| Other time deposits | 213,777 | 324,512 |
| Total deposits | 661,929 | 755,963 |
| SHORT-TERM BORROWINGS | 14,642 | 10,190 |
| FEDERAL HOME LOAN BANK ADVANCES | - | 15,000 |
| OTHER BORROWINGS | - | - |
| GUARANTEED PREFERRED BENEFICIAL INTERESTS IN COMPANY'S SUBORDINATED DEBENTURES | 23,811 | 22,890 |
| ACCRUED INTEREST PAYABLE | 1,098 | 1,468 |
| ACCRUED EXPENSES | 5,712 | 2,946 |
| OTHER LIABILITIES | 5,221 | 2,361 |
| Total liabilities | 712,413 | 810,818 |
| STOCKHOLDERS' EQUITY: | | |
| Preferred stock, \$.01 par value – Authorized 2,000,000 shares: | | |
| Preferred Stock - 5% Series A 20,093 shares issued and outstanding | 19,355 | 19,187 |
| Preferred Stock - 9% Series B 1,005 shares issued and outstanding | 1,081 | 1,098 |
| Common stock, \$.01 par value – Authorized 10,000,000 shares; 3,305,219 and 3,290,219 shares issued and outstanding | 34 | 33 |
| Capital surplus – common stock | 26,988 | 26,885 |
| Retained earnings (deficit) | (7,509) | 16,078 |
| Treasury stock (363,434 shares) | (5,068) | (5,068) |
| Accumulated other comprehensive income (loss), net | 1,697 | (948) |
| Total stockholders' equity | <u>36,578</u> | <u>57,265</u> |
| Total liabilities and stockholders' equity | <u>\$ 748,991</u> | <u>\$ 868,083</u> |

See accompanying notes to consolidated financial statements.

BNCCORP, INC. AND SUBSIDIARIES

Consolidated Statements of Operations
(In thousands, except per share data, unaudited)

| | <u>For the Three Months Ended September 30,</u> | | <u>For the Nine Months Ended September 30,</u> | |
|--|---|--------------------|--|--------------------|
| | <u>2010</u> | <u>2009</u> | <u>2010</u> | <u>2009</u> |
| INTEREST INCOME: | | | | |
| Interest and fees on loans | \$ 6,132 | \$ 7,416 | \$ 18,764 | \$ 22,370 |
| Interest and dividends on investments | | | | |
| Taxable | 1,946 | 4,065 | 6,948 | 10,879 |
| Tax-exempt | 23 | 73 | 69 | 362 |
| Dividends | 32 | 57 | 92 | 92 |
| Total interest income | <u>8,133</u> | <u>11,611</u> | <u>25,873</u> | <u>33,703</u> |
| INTEREST EXPENSE: | | | | |
| Deposits | 2,025 | 3,203 | 6,866 | 9,324 |
| Short-term borrowings | 14 | 56 | 45 | 142 |
| Federal Home Loan Bank advances | - | 196 | 113 | 924 |
| Long-term borrowings | - | - | - | 2 |
| Subordinated debentures | 317 | 303 | 921 | 960 |
| Total interest expense | <u>2,356</u> | <u>3,758</u> | <u>7,945</u> | <u>11,352</u> |
| Net interest income | <u>5,777</u> | <u>7,853</u> | <u>17,928</u> | <u>22,351</u> |
| PROVISION FOR CREDIT LOSSES | <u>1,250</u> | <u>22,300</u> | <u>4,750</u> | <u>26,000</u> |
| NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES | <u>4,527</u> | <u>(14,447)</u> | <u>13,178</u> | <u>(3,649)</u> |
| NON-INTEREST INCOME: | | | | |
| Bank charges and service fees | 629 | 562 | 1,828 | 1,662 |
| Wealth management revenues | 612 | 433 | 1,773 | 1,512 |
| Mortgage banking revenues | 3,248 | 2,163 | 8,262 | 5,655 |
| Gains on sales of loans, net | 212 | 2 | 212 | 88 |
| Gains on sales of securities, net | 517 | 153 | 4,390 | 2,024 |
| Other | 385 | 175 | 984 | 588 |
| Total non-interest income | <u>5,603</u> | <u>3,488</u> | <u>17,449</u> | <u>11,529</u> |
| NON-INTEREST EXPENSE: | | | | |
| Salaries and employee benefits | 3,774 | 3,803 | 11,767 | 11,238 |
| Professional services | 1,354 | 667 | 3,472 | 1,936 |
| Other real estate costs | 1,098 | 4,701 | 1,830 | 7,281 |
| Data processing fees | 737 | 607 | 2,005 | 1,681 |
| Occupancy | 734 | 617 | 2,162 | 1,886 |
| Regulatory costs | 599 | 323 | 1,427 | 1,101 |
| Depreciation and amortization | 336 | 402 | 989 | 1,132 |
| Marketing and promotion | 329 | 360 | 1,003 | 866 |
| Office supplies and postage | 138 | 144 | 444 | 442 |
| Fraud loss on assets serviced by others | - | - | 26,231 | - |
| Other | 593 | 1,121 | 1,818 | 2,632 |
| Total non-interest expense | <u>9,692</u> | <u>12,745</u> | <u>53,148</u> | <u>30,195</u> |
| Income (loss) before income taxes | 438 | (23,704) | (22,521) | (22,315) |
| Income tax expense | - | (1,814) | 72 | (1,564) |
| NET INCOME (LOSS) | 438 | (21,890) | (22,593) | (20,751) |
| Preferred stock costs | (337) | (330) | (992) | (923) |
| Net income (loss) available to common shareholders | <u>\$ 101</u> | <u>\$ (22,220)</u> | <u>\$ (23,585)</u> | <u>\$ (21,674)</u> |
| Basic earnings (loss) per common share | <u>\$ 0.03</u> | <u>\$ (6.81)</u> | <u>\$ (7.19)</u> | <u>\$ (6.64)</u> |
| Diluted earnings (loss) per common share | <u>\$ 0.03</u> | <u>\$ (6.81)</u> | <u>\$ (7.19)</u> | <u>\$ (6.64)</u> |

See accompanying notes to consolidated financial statements.

BNCCORP, INC. AND SUBSIDIARIES
Consolidated Statements of Comprehensive Income
(In thousands, unaudited)

| | For the Three Months Ended September 30, | | For the Nine Months Ended September 30, | |
|---|---|--------------------|--|--------------------|
| | 2010 | 2009 | 2010 | 2009 |
| NET INCOME (LOSS) | \$ 438 | \$ (21,890) | \$ (22,593) | \$(20,751) |
| Unrealized loss on cash flow hedge, net | \$ - | \$ - | \$ - | \$ (375) |
| Amortization of deferred gain in other comprehensive income | \$ - | \$ (378) | \$ (40) | \$ (763) |
| Unrealized gain (loss) on securities available for sale | (351) | 7,086 | 7,075 | 10,971 |
| Reclassification adjustment for (gain) included in net income | <u>(517)</u> | <u>(153)</u> | <u>(4,390)</u> | <u>(2,024)</u> |
| Other comprehensive income (loss), before tax | (868) | 6,555 | 2,645 | 7,809 |
| Income tax expense related to items of other comprehensive income (loss) | <u>-</u> | <u>(2,658)</u> | <u>-</u> | <u>(3,087)</u> |
| Other comprehensive income (loss) | <u>(868)</u> | <u>3,897</u> | <u>2,645</u> | <u>4,722</u> |
| TOTAL COMPREHENSIVE INCOME (LOSS) | <u>\$ (430)</u> | <u>\$ (17,993)</u> | <u>\$ (19,948)</u> | <u>\$ (16,029)</u> |

See accompanying notes to consolidated financial statements.

BNCCORP, INC. AND SUBSIDIARIES
Consolidated Statements of Stockholders' Equity
(In thousands, except share data, unaudited)

| | Preferred Stock | | Common Stock | | Capital Surplus | | Treasury Stock | Accumulated Other Comprehensive | | Total |
|-------------------------------------|-----------------|-----------|--------------|--------|--------------------|----------------------|-------------------|---------------------------------------|-----------|-------|
| | Shares | Amount | Shares | Amount | Common Stock | Retained Earnings | | Income (Loss) | | |
| | | | | | | | | | | |
| BALANCE, December 31, 2008 | - | \$ - | 3,299,163 | \$ 33 | \$ 26,628 | \$ 36,104 | \$ (5,020) | \$ (3,798) | \$ 53,947 | |
| Net loss | - | - | - | - | - | (20,751) | - | - | (20,751) | |
| Other comprehensive gain | - | - | - | - | - | - | - | 4,722 | 4,722 | |
| Preferred stock issued | 21,098 | 21,098 | - | - | - | - | - | - | 21,098 | |
| Discount on preferred stock, net | - | (1,005) | - | - | - | - | - | - | (1,005) | |
| Preferred stock amortization, net | - | 141 | - | - | - | (141) | - | - | - | |
| Accrued dividend on preferred stock | - | - | - | - | - | (780) | - | - | (780) | |
| Impact of share-based compensation | - | - | (5,718) | - | 242 | - | (34) | - | 208 | |
| BALANCE, September 30, 2009 | 21,098 | \$ 20,234 | 3,293,445 | \$ 33 | \$ 26,870 | \$ 14,432 | \$ (5,054) | \$ 924 | \$ 57,439 | |
| BALANCE, December 31, 2009 | 21,098 | \$ 20,285 | 3,290,219 | \$ 33 | \$ 26,885 | \$ 16,078 | \$ (5,068) | \$ (948) | \$ 57,265 | |
| Net loss | - | - | - | - | - | (22,593) | - | - | (22,593) | |
| Other comprehensive gain | - | - | - | - | - | - | - | 2,645 | 2,645 | |
| Preferred stock amortization, net | - | 151 | - | - | - | (151) | - | - | - | |
| Accrued dividend on preferred stock | - | - | - | - | - | (843) | - | - | (843) | |
| Impact of share-based compensation | - | - | 15,000 | 1 | 103 | - | - | - | 104 | |
| BALANCE, September 30, 2010 | 21,098 | \$ 20,436 | 3,305,219 | \$ 34 | \$ 26,988 | \$ (7,509) | \$ (5,068) | \$ 1,697 | \$ 36,578 | |

See accompanying notes to consolidated financial statements.

BNCCORP, INC. AND SUBSIDIARIES
Consolidated Statements of Cash Flows
For the Nine Months Ended September 30,
(In thousands, unaudited)

| | 2010 | 2009 |
|---|-------------|-------------|
| OPERATING ACTIVITIES: | | |
| Net loss | \$ (22,593) | \$ (20,751) |
| Adjustments to reconcile loss to net cash used in operating activities - | | |
| Provision for credit losses | 4,750 | 26,000 |
| Provision for other real estate losses | 1,634 | 7,266 |
| Depreciation and amortization | 989 | 1,134 |
| Net amortization of premiums and (discounts) on investment securities and subordinated debentures | (455) | (2,397) |
| Share-based compensation | 103 | 242 |
| Change in interest receivable and other assets, net | 4,074 | (7,794) |
| Impairment of intangible assets (goodwill) | - | 409 |
| Fraud loss on assets serviced by others | 26,231 | - |
| Loss on sale of other real estate | 147 | - |
| Bank premises and equipment, net charges associated with branch closure | 102 | - |
| Gain on sale of branch | (403) | - |
| Net realized gain on sales of investment securities | (4,390) | (2,024) |
| Provision (benefit) for deferred income taxes | (1,068) | 2,537 |
| Change in other liabilities, net | 4,995 | 1,078 |
| Originations of loans to be participated | (117) | (37,524) |
| Proceeds from participations of loans | 117 | 37,524 |
| Funding of originations of loans held for sale | (419,071) | (368,810) |
| Proceeds from sale of loans held for sale | 393,516 | 358,949 |
| Fair value adjustment for loans held for sale | (1,006) | (424) |
| Net cash used in operating activities | (12,445) | (4,585) |
| INVESTING ACTIVITIES: | | |
| Change in federal funds sold, net | - | (1,000) |
| Purchases of investment securities | (49,946) | (132,222) |
| Proceeds from sales of investment securities | 84,450 | 49,406 |
| Proceeds from maturities of investment securities | 36,055 | 61,000 |
| Purchases of Federal Reserve and Federal Home Loan Bank Stock | (556) | (1,157) |
| Sales of Federal Reserve and Federal Home Loan Bank Stock | 742 | - |
| Net increase in participating interests in mortgage loans | (640) | (2,852) |
| Net decrease (increase) in loans held for investment | 57,249 | (24,657) |
| Proceeds from sale of other real estate | 2,995 | 519 |
| Sale of bank premises and equipment | 109 | 14 |
| Additions to bank premises and equipment | (297) | (941) |
| Net cash provided by (used in) investing activities | 130,161 | (51,890) |

See accompanying notes to consolidated financial statements.

BNCCORP, INC. AND SUBSIDIARIES
Consolidated Statements of Cash Flows, continued
For the Nine Months Ended September 30,
(In thousands, unaudited)

| | 2010 | 2009 |
|---|-------------|-------------|
| FINANCING ACTIVITIES: | | |
| Net increase (decrease) in deposits | (94,034) | 102,544 |
| Net increase in short-term borrowings | 4,452 | 3,696 |
| Repayments of Federal Home Loan Bank advances | (19,900) | (1,063,500) |
| Proceeds from Federal Home Loan Bank advances | 4,900 | 994,000 |
| Proceeds from issuance of preferred stock | - | 20,093 |
| Dividends paid on preferred stock | - | (781) |
| Net cash provided by (used in) financing activities | (104,582) | 56,052 |
| NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS | 13,134 | (423) |
| CASH AND CASH EQUIVALENTS, beginning of period | 35,362 | 10,570 |
| CASH AND CASH EQUIVALENTS, end of period | \$ 48,496 | \$ 10,147 |
| SUPPLEMENTAL CASH FLOW INFORMATION: | | |
| Interest paid | \$ 8,315 | \$ 11,058 |
| Income taxes paid (received) | \$ (6,261) | \$ 2,574 |
| SUPPLEMENTAL DISCLOSURE OF NONCASH INVESTING AND FINANCING ACTIVITIES: | | |
| Additions to other real estate in settlement of loans | \$ 8,093 | \$ 8,042 |

See accompanying notes to consolidated financial statements.

BNCCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
September 30, 2010

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 18 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 September 30, 2010 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, 2009. Accordingly, footnote disclosures which would substantially duplicate the disclosures contained in the December 31, 2009 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, 2009 and the notes thereto.

The Company's critical accounting policies are unchanged since December 31, 2009.

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):

| | <u>Actual</u> | |
|---|---------------|--------------|
| | <u>Amount</u> | <u>Ratio</u> |
| September 30, 2010 | | |
| Total Capital (to risk-weighted assets): | | |
| Consolidated | \$ 65,502 | 12.25 % |
| BNC National Bank | 63,657 | 11.92 |
| Tier 1 Capital (to risk-weighted assets): | | |
| Consolidated | 46,509 | 8.70 |
| BNC National Bank | 56,856 | 10.64 |
| Tier 1 Capital (to average assets): | | |
| Consolidated | 46,509 | 6.06 |
| BNC National Bank | 56,856 | 7.43 |
| Tangible Capital (to total assets): | | |
| Consolidated tangible equity | 36,389 | 4.86 |
| BNC National Bank | 58,817 | 7.87 |
| Tangible Common Capital (to total assets): | | |
| Consolidated tangible common equity | 15,953 | 2.13 |
| December 31, 2009 | | |
| Total Capital (to risk-weighted assets): | | |
| Consolidated | \$ 89,102 | 14.15 % |
| BNC National Bank | 85,195 | 13.52 |
| Tier 1 Capital (to risk-weighted assets): | | |
| Consolidated | 77,617 | 12.32 |
| BNC National Bank | 77,192 | 12.25 |
| Tier 1 Capital (to average assets): | | |
| Consolidated | 77,617 | 8.58 |
| BNC National Bank | 77,192 | 8.54 |
| Tangible Capital (to total assets): | | |
| Consolidated tangible equity | 57,018 | 6.57 |
| BNC National Bank | 74,989 | 8.65 |
| Tangible Common Capital (to total assets): | | |
| Consolidated tangible common equity | 36,733 | 4.23 |

BNCCORP and the Bank are subject to various regulatory capital requirements administered by the Federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory - and possibly additional discretionary - actions by regulators that, if undertaken, could have a direct material effect on the Company's financial results. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, BNCCORP and the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices.

As of September 30, 2010, the Bank was well-capitalized under the regulatory framework for prompt corrective action.

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.

NOTE 4 – Recently Issued or Adopted Accounting Standards

FASB ASC 810, *Consolidation*, requires a qualitative rather than a quantitative analysis to determine the primary beneficiary of a variable interest entity (VIE) for consolidation purposes. The primary beneficiary of a VIE is the enterprise that has the power to direct the activities of the VIE that most significantly impact the VIE's economic performance and also has the obligation to absorb the losses of the VIE that could potentially be significant to the VIE or the right to receive benefits of the VIE that could potentially be significant to the VIE. The provisions of ASC 810 were effective January 1, 2010. The adoption of ASC 810 did not have a material impact on our consolidated financial statements.

FASB ASC 860, *Transfers and Servicing*, removes the concept of a qualifying special-purpose entity. It clarifies that a transferor must evaluate whether it has maintained effective control of a financial asset by considering its continuing direct or indirect involvement with the transferred financial asset. The provisions of ASC 860 were effective for financial asset transfers occurring after December 31, 2009. The adoption of ASC 860 did not have a material impact on our consolidated financial statements.

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 is not expected to have a material effect on the Company's consolidated financial statements.

NOTE 5 – 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):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--------------------------------------|---|------------------|--|------------------|
| | 2010 | 2009 | 2010 | 2009 |
| Balance, beginning of period | \$ 12,315 | \$ 12,984 | \$ 7,253 | \$ 10,189 |
| Transfers from nonperforming loans | 829 | 2,322 | 8,093 | 8,042 |
| Real estate sold | (1,581) | (258) | (2,995) | (519) |
| Net gains (losses) on sale of assets | 8 | - | (147) | - |
| Provision | (1,000) | (4,602) | (1,633) | (7,266) |
| Balance, end of period | <u>\$ 10,571</u> | <u>\$ 10,446</u> | <u>\$ 10,571</u> | <u>\$ 10,446</u> |

NOTE 6 – Earnings Per Share

The following table shows the amounts used in computing per share results:

| | Three months ended September 30, 2010 | Nine months ended September 30, 2010 |
|--|--|---|
| Denominator for basic earnings (loss) per share: | | |
| Average common shares outstanding | 3,281,719 | 3,281,719 |
| Dilutive common stock options | 0 | 0 |
| Denominator for diluted earnings (loss) per share | 3,281,719 | 3,281,719 |
| Numerator (in thousands): | | |
| Net income (loss) | \$ 438 | \$ (22,593) |
| Preferred stock costs | (337) | (992) |
| Net income (loss) available to common shareholders | \$ 101 | \$ (23,585) |
| Basic earnings (loss) per common share | \$ 0.03 | \$ (7.19) |
| Diluted earnings (loss) per common share | \$ 0.03 | \$ (7.19) |
| | Three months ended September 30, 2009 | Nine months ended September 30, 2009 |
| Denominator for basic loss per share: | | |
| Average common shares outstanding | 3,261,831 | 3,261,831 |
| Dilutive common stock options | 7,524 | 15,855 |
| Denominator for diluted loss per share | 3,269,355 | 3,277,686 |
| Numerator (in thousands): | | |
| Net loss | \$ (21,890) | \$ (20,751) |
| Preferred stock costs | (330) | (923) |
| Net loss available to shareholders | \$ (22,220) | \$ (21,674) |
| Basic loss per common share | \$ (6.81) | \$ (6.64) |
| Diluted loss per common share | \$ (6.81) | \$ (6.64) |

For the three months ended September 30, 2010 and 2009, there were 269,700 options and 9,700 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. For the nine months ended September 30, 2010 and 2009, there were 269,700 options and 9,700 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.

NOTE 7 – 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:

| | 1995 | 2002 | 2006 | 2010 |
|------------------------------------|-------------|-------------|-------------|-------------|
| Maximum shares/options allowed | 250,000 | 125,000 | 200,000 | 250,000 |
| Remaining shares/options available | 49,651 | - | 3,850 | 250,000 |

The Company granted 240,000 stock options on March 17, 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 September 30, 2010 and \$76,000 for the nine month period ended September 30, 2010 relating to share options. The Company recognized share-based compensation expense of \$0 for the three and nine month periods ended September 30, 2009 relating to share options. At September 30, 2010, the Company had \$204,000 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 September 30, 2010:

| | <u>Stock Options Outstanding</u> | <u>Stock Options Currently Exercisable</u> | <u>Stock Options Vested and Expected to Vest</u> |
|---|--------------------------------------|--|--|
| Number | 269,700 | 41,700 | 269,700 |
| Weighted-average exercise price | \$3.49 | \$6.20 | \$3.49 |
| Weighted-average remaining contractual term | 8.1 years | 0.7 years | 8.1 years |

There were 10,000 shares of restricted stock granted in the three month period ending September 30, 2010 and 15,000 shares of restricted stock granted in the nine month period ending September 30, 2010. The Company recognized share-based compensation expense of \$11,000 related to restricted stock for the three month period ended September 30, 2010, and \$27,000 for the nine month period ended September 30, 2010. The Company recognized share-based compensation expense of \$69,000 related to restricted stock for the three month period ended September 30, 2009 and \$242,000 for the nine month period ended September 30, 2009.

At September 30, 2010, the Company had \$88,100 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 8 – Derivative Instruments and Hedging Activities

Risk Management Objective of Using Derivatives

The Company is exposed to certain risks arising from both its business operations and economic conditions. The Company manages economic risks, including interest rate and liquidity risk, primarily by managing the amount, sources, and duration of its assets and liabilities and secondarily through the use of derivative financial instruments. Specifically, the Company enters into derivative financial instruments to manage exposures that arise from business activities that result in the receipt or payment of future known and uncertain cash amounts, the value of which are determined by interest rates. The Company's derivative financial instruments are used to manage differences in the amount, timing, and duration of the Company's known or expected cash receipts and its known or expected cash payments principally related to certain variable-rate loan assets.

Fair Values of Derivative Instruments on the Consolidated Balance Sheets

The Company had an interest rate floor that matured in January 2010. The table below presents the fair value of the Company's derivative financial instruments as well as their classification on the Consolidated Balance

Sheets as of the periods indicated below (in thousands):

Tabular Disclosure of Fair Values of Derivative Instruments

| | Asset Derivatives | | | | Liability Derivatives | | | |
|--|---------------------------------|-------------------|--------------------------------|-------------------|---------------------------------|-------------------|--------------------------------|-------------------|
| | As of September 30, 2010 | | As of December 31, 2009 | | As of September 30, 2010 | | As of December 31, 2009 | |
| | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value |
| Derivatives Designated as Hedging Instruments | | | | | | | | |
| Interest Rate Floor | Other Assets | \$ - | Other Assets | \$ - | Other Liabilities | \$ - | Other Liabilities | \$ - |
| Total Derivatives Designated as Hedging Instruments | | <u>\$ -</u> | | <u>\$ -</u> | | <u>\$ -</u> | | <u>\$ -</u> |
| Derivatives Not Designated as Hedging Instruments | | | | | | | | |
| Interest Rate Floor | Other Assets | \$ - | Other Assets | \$ 49 | Other Liabilities | \$ - | Other Liabilities | \$ - |
| Total Derivatives Not Designated as Hedging Instruments | | <u>\$ -</u> | | <u>\$ 49</u> | | <u>\$ -</u> | | <u>\$ -</u> |

Cash Flow Hedges of Interest Rate Risk

The Company's objective in using interest rate derivatives is to manage its exposure to interest rate movements. To accomplish this objective, the Company primarily used interest rate floors as part of its interest rate risk management strategies. Interest rate floors involve the receipt of variable-rate amounts from a counterparty if interest rates fall below the strike rate on the contract in exchange for an up front premium.

Effect of Derivative Instruments on the Consolidated Statements of Operations

The tables below present the effect of the Company's derivative financial instruments on the Consolidated Statements of Operations for the three and nine months ended September 30 (in thousands):

| Derivatives in Cash Flow Hedging Relationships | Amount of Gain or (Loss) Recognized in OCI on Derivative (Effective Portion) | | Location of Gain or (Loss) Reclassified from Accumulated OCI into Income (Effective Portion) | Amount of Gain or (Loss) Reclassified from Accumulated OCI into Income (Effective Portion) | | Location of Gain or (Loss) Recognized in Income on Derivative (Ineffective portion and Amount Excluded from Effectiveness Testing) | Amount of Gain or (Loss) Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing) | |
|--|--|------|--|--|--------|--|--|------|
| | Three Months Ended September 30, | | | Three Months Ended September 30, | | | Three Months Ended September 30, | |
| | 2010 | 2009 | | 2010 | 2009 | | 2010 | 2009 |
| Interest Rate Floor | \$ - | \$ - | Interest Income | \$ - | \$ 379 | Other Income | \$ - | \$ - |
| | | | Other Income | - | - | | | |
| Total | \$ - | \$ - | | \$ - | \$ 379 | | \$ - | \$ - |

| Derivatives in Cash Flow Hedging Relationships | Amount of Gain or (Loss) Recognized in OCI on Derivative (Effective Portion) | | Location of Gain or (Loss) Reclassified from Accumulated OCI into Income (Effective Portion) | Amount of Gain or (Loss) Reclassified from Accumulated OCI into Income (Effective Portion) | | Location of Gain or (Loss) Recognized in Income on Derivative (Ineffective portion and Amount Excluded from Effectiveness Testing) | Amount of Gain or (Loss) Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing) | |
|--|--|-------|--|--|----------|--|--|---------|
| | Nine Months Ended September 30, | | | Nine Months Ended September 30, | | | Nine Months Ended September 30, | |
| | 2010 | 2009 | | 2010 | 2009 | | 2010 | 2009 |
| Interest Rate Floor | \$ - | \$ 43 | Interest Income | \$ 40 | \$ 1,182 | Other Income | \$ - | \$ (12) |
| | | | Other Income | - | - | | | |
| Total | \$ - | \$ 43 | | \$ 40 | \$ 1,182 | | \$ - | \$ (12) |

Non-designated Hedges

The Company does not use derivatives for trading or speculative purposes. Derivatives not designated as hedges are used to manage the Company's exposure to interest rate movements and other identified risks but do not meet the strict hedge accounting requirements. Changes in the fair value of derivatives not designated in hedging relationships are recorded directly in earnings. The Company's \$50 million interest rate floor disqualified for hedge accounting as of April 1, 2009; accordingly, the changes in fair value of the floor subsequent to March 31, 2009 were recognized directly in earnings.

The amount recorded in operations shown in the table below represents the net effect of changes in fair value of the interest rate floor and cash receipts for the three and nine months ended September 30 (in thousands):

| Derivatives Not Designated as Hedging Instruments | Location of Gain or (Loss) Recognized in Income on Derivative | Amount of Gain or (Loss) Recognized in Income on Derivative | | | |
|---|---|---|--------------|---------------------------------|--------------|
| | | Three Months Ended September 30, | | Nine Months Ended September 30, | |
| | | 2010 | 2009 | 2010 | 2009 |
| Interest Rate Floor | Other Income | \$ - | \$ 12 | \$ (7) | \$ 37 |
| Total | | <u>\$ -</u> | <u>\$ 12</u> | <u>\$ (7)</u> | <u>\$ 37</u> |

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 September 30, 2010 or December 31, 2009. The carrying amount of available-for-sale securities and their approximate fair values were as follows (in thousands):

| | September 30, 2010 | | | |
|--|---------------------------|---------------------------------------|--|---------------------------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| U.S. government agency mortgage-backed securities guaranteed by GNMA | \$ 1,010 | \$ 55 | \$ - | \$ 1,065 |
| U.S. government agency mortgage-backed securities issued by FNMA | 1,998 | 109 | (2) | 2,105 |
| Collateralized mortgage obligations guaranteed by GNMA | 95,478 | 647 | (661) | 95,464 |
| Collateralized mortgage obligations issued by FNMA or FHLMC | 1,009 | 45 | - | 1,054 |
| Other collateralized mortgage obligations | 46,611 | 2,160 | (350) | 48,421 |
| State and municipal bonds | 1,887 | 326 | - | 2,213 |
| | <u>\$ 147,993</u> | <u>\$ 3,342</u> | <u>\$ (1,013)</u> | <u>\$ 150,322</u> |

| | December 31, 2009 | | | |
|--|---------------------------|---------------------------------------|--|---------------------------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| U.S. government agency mortgage-backed securities guaranteed by GNMA | \$ 1,223 | \$ 39 | \$ - | \$ 1,262 |
| U.S. government agency mortgage-backed securities issued by FNMA | 2,500 | 102 | (3) | 2,599 |
| Collateralized mortgage obligations guaranteed by GNMA | 86,600 | 531 | (114) | 87,017 |
| Collateralized mortgage obligations issued by FNMA or FHLMC | 1,797 | 90 | - | 1,887 |
| Other collateralized mortgage obligations | 118,375 | 3,349 | (4,513) | 117,211 |
| State and municipal bonds | 2,521 | 164 | - | 2,685 |
| | <u>\$ 213,016</u> | <u>\$ 4,275</u> | <u>\$ (4,630)</u> | <u>\$ 212,661</u> |

The amortized cost and estimated fair market value of available-for-sale securities classified according to their contractual maturities at September 30, 2010 were as follows (in thousands):

| | Amortized Cost | Estimated Fair Value |
|--|---------------------------|---------------------------------|
| Due in one year or less | \$ - | \$ - |
| Due after one year through five years | - | - |
| Due after five years through ten years | 6,088 | 6,762 |
| Due after ten years | 141,905 | 143,560 |
| Total | <u>\$ 147,993</u> | <u>\$ 150,322</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):

| Description of Securities | September 30, 2010 | | | | | | | | |
|--|---------------------|------------------|-----------------|-------------------|-----------------|-----------------|-----------|------------------|-------------------|
| | 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 | 9 | 38,757 | (661) | - | - | - | 9 | 38,757 | (661) |
| Collateralized mortgage obligations issued by FNMA or FHLMC | - | - | - | - | - | - | - | - | - |
| Other collateralized mortgage obligations | 2 | 1,358 | (10) | 2 | 7,298 | (340) | 4 | 8,656 | (350) |
| State and municipal bonds | - | - | - | - | - | - | - | - | - |
| Total temporarily impaired securities | 11 | \$ 40,115 | \$ (671) | 3 | \$ 7,354 | \$ (342) | 14 | \$ 47,469 | \$ (1,013) |

| Description of Securities | December 31, 2009 | | | | | | | | |
|--|---------------------|------------------|-------------------|-------------------|------------------|-------------------|-----------|------------------|-------------------|
| | 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 | (3) | 1 | 57 | (3) |
| Collateralized mortgage obligations guaranteed by GNMA | 6 | 34,394 | (114) | - | - | - | 6 | 34,394 | (114) |
| Collateralized mortgage obligations issued by FNMA or FHLMC | - | - | - | - | - | - | - | - | - |
| Other collateralized mortgage obligations | 8 | 29,622 | (1,715) | 8 | 22,591 | (2,798) | 16 | 52,213 | (4,513) |
| State and municipal bonds | - | - | - | - | - | - | - | - | - |
| Total temporarily impaired securities | 14 | \$ 64,016 | \$ (1,829) | 9 | \$ 22,648 | \$ (2,801) | 23 | \$ 86,664 | \$ (4,630) |

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 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 September 30, 2010, 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 but one security in an unrealized loss position are investment grade. For the one non-investment grade security and for the one security that had been in an unrealized loss position for a longer period, we obtained credit surveillance reports that provide prospective analysis of the securities performance under various scenarios. The credit surveillance reports do not currently project credit losses on either of these securities.

There were no securities that management concluded were other-than-temporarily impaired at September 30, 2010.

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):

| | Carrying Value at September 30, 2010 | | | |
|---|---|----------------|-------------------|----------------|
| | Total | Level 1 | Level 2 | Level 3 |
| ASSETS | | | | |
| Securities available for sale | \$ 150,322 | \$ - | \$ 150,322 | \$ - |
| Loans held for sale | 50,691 | - | 50,691 | - |
| Commitments to originate mortgage loans | 2,673 | - | 2,673 | - |
| Interest rate floor | - | - | - | - |
| Total assets at fair value | <u>\$ 203,686</u> | <u>\$ -</u> | <u>\$ 203,686</u> | <u>\$ -</u> |
| LIABILITIES | | | | |
| Commitments to sell mortgage loans | \$ 3,926 | \$ - | \$ 3,926 | \$ - |
| Total liabilities at fair value | <u>\$ 3,926</u> | <u>\$ -</u> | <u>\$ 3,926</u> | <u>\$ -</u> |

| | Carrying Value at September 30, 2009 | | | |
|---|---|----------------|-------------------|----------------|
| | Total | Level 1 | Level 2 | Level 3 |
| ASSETS | | | | |
| Securities available for sale | \$ 244,592 | \$ - | \$ 244,592 | \$ - |
| Loans held for sale | 23,689 | - | 23,689 | - |
| Commitments to originate mortgage loans | 1,225 | - | 1,225 | - |
| Interest rate floor | 542 | - | 542 | - |
| Total assets at fair value | <u>\$ 270,048</u> | <u>\$ -</u> | <u>\$ 270,048</u> | <u>\$ -</u> |
| LIABILITIES | | | | |
| Commitments to sell mortgage loans | \$ 1,917 | \$ - | \$ 1,917 | \$ - |
| Total liabilities at fair value | <u>\$ 1,917</u> | <u>\$ -</u> | <u>\$ 1,917</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 and nine month periods ending September 30, 2010 and September 30, 2009.

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):

| | Carrying Value at September 30, 2010 | | | | Total gains/ (losses) |
|----------------------------------|---|----------------|----------------|------------------|----------------------------------|
| | Total | Level 1 | Level 2 | Level 3 | |
| Impaired loans ⁽¹⁾ | \$ 31,035 | \$ - | \$ - | \$ 31,035 | \$ (2,458) |
| Other real estate ⁽²⁾ | 10,571 | - | - | 10,571 | (1,780) |
| Total | <u>\$ 41,606</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ 41,606</u> | <u>\$ (4,238)</u> |

Carrying Value at December 31, 2009

| | <u>Total</u> | <u>Level 1</u> | <u>Level 2</u> | <u>Level 3</u> | <u>Total gains/ (losses) ⁽³⁾</u> |
|----------------------------------|------------------|----------------|----------------|------------------|---|
| Impaired loans ⁽¹⁾ | \$ 32,200 | \$ - | \$ - | \$ 32,200 | \$ (7,268) |
| Other real estate ⁽²⁾ | 7,253 | - | - | 7,253 | (8,056) |
| Total | <u>\$ 39,453</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ 39,453</u> | <u>\$ (15,324)</u> |

(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.

(3) The information presented is for the year ended December 31, 2009.

At the beginning of the period, all assets and liabilities valued at fair value on a nonrecurring basis were considered to be Level 3. There were no transfers into or out of Level 3 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):

| | <u>September 30, 2010</u> | | <u>December 31, 2009</u> | |
|---|----------------------------|-----------------------|----------------------------|-----------------------|
| | <u>Carrying Amount</u> | <u>Fair Value</u> | <u>Carrying Amount</u> | <u>Fair Value</u> |
| Assets: | | | | |
| Cash and cash equivalents | \$ 48,496 | \$ 48,496 | \$ 35,362 | \$ 35,362 |
| Investment securities available for sale | 150,322 | 150,322 | 212,661 | 212,661 |
| Federal Reserve Bank and Federal Home Loan Bank stock | 2,862 | 2,862 | 3,048 | 3,048 |
| Loans held for sale | 50,691 | 50,691 | 24,130 | 24,130 |
| Participating interests in mortgage loans | 12,943 | 12,943 | 38,534 | 38,534 |
| Loans and leases held for investment, net | 428,969 | 428,594 | 499,061 | 494,242 |
| Accrued interest receivable | 2,342 | 2,342 | 2,970 | 2,970 |
| Derivative financial instruments | - | - | 216 | 216 |
| | <u>696,625</u> | <u>\$ 696,250</u> | <u>815,982</u> | <u>\$ 811,163</u> |
| Other assets | <u>52,366</u> | | <u>52,101</u> | |
| | <u>\$ 748,991</u> | | <u>\$ 868,083</u> | |
| Liabilities and Stockholders' Equity: | | | | |
| Deposits, noninterest-bearing | \$ 114,050 | \$ 114,050 | \$ 98,658 | \$ 98,658 |
| Deposits, interest-bearing | 547,879 | 549,615 | 657,305 | 658,647 |
| Borrowings and advances | 14,642 | 14,642 | 25,190 | 25,278 |
| Accrued interest payable | 1,098 | 1,098 | 1,468 | 1,468 |
| Guaranteed preferred beneficial interests in Company's subordinated debentures | 23,811 | 13,118 | 22,890 | 11,266 |
| | <u>701,480</u> | <u>\$ 692,523</u> | <u>805,511</u> | <u>\$ 795,317</u> |
| Other liabilities | 10,933 | | 5,307 | |
| Stockholders' equity | <u>36,578</u> | | <u>57,265</u> | |
| | <u>\$ 748,991</u> | | <u>\$ 868,083</u> | |
| Financial instruments with off-balance-sheet risk: | | | | |
| Commitments to extend credit | | \$ 35 | | \$ 64 |
| Standby and commercial letters of credit | | 30 | | 41 |
| Mortgage banking commitments to fund loans | | 2,621 | | 427 |
| Mortgage banking commitments to sell loans | | (3,874) | | (675) |

NOTE 12. Fraud Loss on Assets Serviced by Others

As previously reported, the Company discovered fraudulent activity in April of this year by a third-party servicing company in relation to residential mortgage loans serviced by the third-party. Since April, the Company and its advisors have been diligently addressing this matter. In the second quarter, the Company determined the scope of the fraud losses and recorded a loss of \$26.231 million. Our internal and external investigations have confirmed that this fraudulent activity was limited to this single servicing company and that no bank employees were involved in or were aware of this wrongful conduct by the servicing company.

The Company is currently pursuing available remedies, and is committed to taking such other actions that may be reasonably available to recover the losses associated with this matter. We have submitted claims under our fidelity insurance policies seeking to recover the insured portion of these losses, which policies together provide for total coverage of \$15 million. However, as of mid October, our insurance carriers commenced a declaratory judgment action against us in an Arizona federal court seeking a judicial determination that the losses associated with the third-party servicing fraud are not covered by the policy. We intend to vigorously pursue our claims for recovery under our insurance policies and believe we have a strong claim under the policies. However, we can provide no assurances as to the outcome of this litigation.

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 and Nine Months Ended September 30, 2010 and 2009

Summary for the Three Months Ended September 30, 2010 and 2009

Net income was \$438 thousand, and the net income available to common shareholders was \$101 thousand, or \$0.03 per share on a diluted basis, for the quarter ended September 30, 2010, compared to a net loss of \$(21.890) million or \$(6.81) per diluted share, in the third quarter of 2009.

Net interest income for the third quarter of 2010 was \$5.777 million, a decrease of \$2.076 million, or 26.4%, from \$7.853 million in the same period of 2009. The net interest margin for the current period decreased to 3.27% from 3.70%.

In the third quarter of 2010 and 2009, the Company's provision for credit losses was \$1.250 million and \$22.300 million, respectively.

Non-interest income for the third quarter of 2010 was \$5.603 million. This compares to non-interest income of \$3.488 million for the same period in 2009, an increase of \$2.115 million, or 60.6%.

Non-interest expense for the third quarter of 2010 was \$9.692 million compared to \$12.745 million in the same period of 2009, a decrease of \$3.053 million, or 24.0%.

Tax expense of \$0 was recognized in the third quarter of 2010 as the Company has net operating loss carryforwards for federal and state tax purposes. A tax benefit of \$1.814 million, or 7.7% of the pre-tax loss, was recognized in the third quarter of 2009.

Summary for the Nine Months Ended September 30, 2010 and 2009

Net loss was \$(22.593) million, and the loss available to common shareholders was \$(23.585) million, or \$(7.19) per share on a diluted basis, for the nine months ended September 30, 2010. The results for the first nine months of 2010 include a fraud loss on assets serviced by others of \$(26.231) million, compared to a net loss of \$(20.751) million or \$(6.64) per diluted share, in the first nine months of 2009.

Net interest income for the nine months ended September 30, 2010 was \$17.928 million, a decrease of \$4.423 million, or 19.8%, from \$22.351 million in the same period of 2009. The year to date net interest margin decreased to 3.25% from 3.62%.

In the first nine months of 2010 and 2009, the Company's provision for credit losses was \$4.750 million and \$26.000 million, respectively.

Non-interest income for the nine months ended September 30, 2010 was \$17.449 million. This compares to non-interest income of \$11.529 million for the same period in 2009, an increase of \$5.920 million, or 51.3%.

Non-interest expense, excluding the fraud loss on assets service by others of \$(26.231) million for the nine months ended September 30, 2010 was \$26.917 million compared to \$30.195 million in the same period of 2009, a decrease of \$3.278 million, or 10.9%.

Tax expense of \$72 thousand or (0.3)% of pre-tax loss, was recognized in the first nine months of 2010. A tax benefit of \$1.564 million, or 7.0% of the pre-tax loss, was recognized in the nine month period ended September 30, 2009.

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 September 30, | | | | | | | | |
|---|----------------------------------|-------------------------------|-----------------------------|--------------------|-------------------------------|-----------------------------|---------------------|-------------------------------|-----------------------------|
| | 2010 | | | 2009 | | | 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 |
| Interest-earning assets | | | | | | | | | |
| Federal funds sold/cash equivalents | \$ 44,251 | \$ 24 | 0.22% | \$ 4,004 | \$ 3 | 0.30% | \$ 40,247 | \$ 21 | -0.08%(a) |
| Investments - taxable | 155,019 | 1,954 | 5.00% | 236,599 | 4,119 | 6.91% | (81,580) | (2,165) | -1.91%(b) |
| Investments - tax exempt | 2,143 | 23 | 4.26% | 5,796 | 73 | 5.00% | (3,653) | (50) | -0.74%(b) |
| Loans held for sale | 34,904 | 375 | 4.26% | 21,515 | 282 | 5.20% | 13,389 | 93 | -0.94%(c) |
| Participating interests in mortgage loans | 14,868 | 166 | 4.43% | 29,584 | 351 | 4.71% | (14,716) | (185) | -0.28%(d) |
| Loans and leases held for investment | 466,209 | 5,591 | 4.76% | 553,747 | 6,783 | 4.86% | (87,538) | (1,192) | -0.10%(e) |
| Allowance for loan losses | (16,825) | | | (9,316) | - | | (7,509) | - | |
| Total interest-earning assets | <u>\$ 700,569</u> | <u>\$ 8,133</u> | 4.61% | <u>\$ 841,929</u> | <u>\$ 11,611</u> | 5.47% | <u>\$ (141,360)</u> | <u>\$ (3,478)</u> | -0.86% |
| Interest-bearing liabilities | | | | | | | | | |
| Interest checking and money market accounts | \$ 291,816 | \$ 427 | 0.58% | \$ 265,961 | \$ 616 | 0.92% | \$ 25,855 | \$ (189) | -0.34%(f) |
| Savings | 10,917 | 3 | 0.11% | 11,553 | 3 | 0.10% | (636) | - | 0.01% |
| Certificates of deposit under \$100,000 | 215,446 | 1,366 | 2.52% | 348,598 | 2,248 | 2.56% | (133,152) | (882) | -0.04%(g) |
| Certificates of deposit \$100,000 and over | 43,159 | 229 | 2.11% | 48,936 | 335 | 2.72% | (5,777) | (106) | -0.61%(g) |
| Total interest-bearing deposits | 561,338 | 2,025 | 1.43% | 675,048 | 3,202 | 1.88% | (113,710) | (1,177) | -0.45% |
| Short-term borrowings | 10,495 | 14 | 0.53% | 20,552 | 56 | 1.08% | (10,057) | (42) | -0.55%(h) |
| Federal Home Loan Bank advances | 1 | - | 0.00% | 31,647 | 196 | 2.46% | (31,646) | (196) | -2.46%(i) |
| Other borrowings | 2 | - | 0.00% | 52 | 1 | 7.63% | (50) | (1) | -7.63% |
| Subordinated debentures | 23,642 | 317 | 5.32% | 22,602 | 303 | 5.32% | 1,040 | 14 | 0.00% |
| Total borrowings | 34,140 | 331 | 3.85% | 74,853 | 556 | 2.95% | (40,713) | (225) | 0.90% |
| Total interest-bearing liabilities | <u>\$ 595,478</u> | <u>2,356</u> | 1.57% | <u>\$ 749,901</u> | <u>3,758</u> | 1.99% | <u>\$ (154,423)</u> | <u>(1,402)</u> | -0.42% |
| Net interest income/spread | | <u>\$ 5,777</u> | 3.04% | | <u>\$ 7,853</u> | 3.48% | | <u>\$ (2,076)</u> | -0.44% |
| Net interest margin | | | 3.27% | | | 3.70% | | | -0.43% |
| Notation: | | | | | | | | | |
| Non-interest-bearing deposits | <u>\$ 122,164</u> | - | | <u>\$ 79,965</u> | - | | <u>\$ 42,199</u> | - | (f) |
| Total deposits | <u>\$ 683,502</u> | <u>\$ 2,025</u> | 1.18% | <u>\$ 755,013</u> | <u>\$ 3,202</u> | 1.68% | <u>\$ (71,511)</u> | <u>\$ (1,177)</u> | -0.50% |
| Taxable equivalents: | | | | | | | | | |
| Total interest-earning assets | \$ 700,569 | \$ 8,148 | 4.61% | \$ 841,929 | \$ 11,651 | 5.49% | | | |
| Net interest income/spread | - | \$ 5,792 | 3.04% | - | \$ 7,893 | 3.50% | | | |
| Net interest margin | - | - | 3.28% | - | - | 3.72% | | | |

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 as a result the average balance of cash equivalents increased.
- Taxable investments decreased due to sales and repayments. Tax exempt investments were sold during 2009 and therefore the average balance has declined. These investments were sold because tax exempt income was less important and because of concerns about the financial stability of issuers.
- 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 12 to the quarterly report for explanation of decrease. The amount of participating interest in mortgage loans will vary depending on the level of originations by counterparties.
- The balance of loans has declined due to repayments, sales, foreclosures and charge-offs.
- Checking and money market accounts have grown due to the success of a new initiative designed to grow deposits.
- In 2010, the balances of certificates have declined as we have been focusing on reducing the cost of funds.
- The increase in non-interest bearing deposits has reduced the need for short-term borrowings.
- The average balance of FHLB advances decreased because we have been able to fund more of our assets with deposits.

Nine Months Ended September 30,

| | 2010 | | | 2009 | | | 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 |
| Interest-earning assets | | | | | | | | | |
| Federal funds sold/cash equivalents | \$ 39,722 | \$ 70 | 0.24% | \$ 1,695 | \$ 3 | 0.24% | \$ 38,027 | \$ 67 | 0.00%(a) |
| Investments - taxable | 175,176 | 6,970 | 5.32% | 222,306 | 10,968 | 6.60% | (47,130) | (3,998) | -1.28%(b) |
| Investments - tax exempt | 2,078 | 69 | 4.44% | 9,601 | 362 | 5.04% | (7,523) | (293) | -0.60%(b) |
| Loans held for sale | 24,195 | 834 | 4.61% | 23,296 | 882 | 5.06% | 899 | (48) | -0.45%(c) |
| Participating interests in mortgage loans | 22,676 | 527 | 3.11% | 28,372 | 909 | 4.28% | (5,696) | (382) | -1.17%(d) |
| Loans and leases held for investment | 491,843 | 17,403 | 4.73% | 550,092 | 20,579 | 5.00% | (58,249) | (3,176) | -0.27%(e) |
| Allowance for loan losses | (17,409) | - | - | (9,000) | - | - | (8,409) | - | - |
| Total interest-earning assets | <u>\$ 738,281</u> | <u>\$ 25,873</u> | 4.69% | <u>\$ 826,362</u> | <u>\$ 33,703</u> | 5.45% | <u>\$ (88,081)</u> | <u>\$ (7,830)</u> | -0.76% |
| Interest-bearing liabilities | | | | | | | | | |
| Interest checking and money market accounts | \$ 282,868 | \$ 1,369 | 0.65% | \$ 261,822 | \$ 1,746 | 0.89% | \$ 21,046 | \$ (377) | -0.24%(f) |
| Savings | 10,885 | 8 | 0.10% | 11,984 | 10 | 0.11% | (1,099) | (2) | -0.01% |
| Certificates of deposit under \$100,000 | 251,843 | 4,740 | 2.52% | 317,983 | 6,558 | 2.76% | (66,140) | (1,818) | -0.24%(g) |
| Certificates of deposit \$100,000 and over | 45,666 | 749 | 2.19% | 45,895 | 1,010 | 2.94% | (229) | (261) | -0.75%(g) |
| Total interest-bearing deposits | 591,262 | 6,866 | 1.55% | 637,684 | 9,324 | 1.95% | (46,422) | (2,458) | -0.40% |
| Short-term borrowings | 9,719 | 45 | 0.62% | 18,471 | 142 | 1.03% | (8,752) | (97) | -0.41%(h) |
| Federal Home Loan Bank advances | 3,865 | 112 | 3.87% | 63,334 | 924 | 1.95% | (59,469) | (812) | 1.92%(i) |
| Other borrowings | 14 | 1 | 9.55% | 65 | 2 | 4.11% | (51) | (1) | 5.44% |
| Subordinated debentures | 23,335 | 921 | 5.28% | 22,666 | 960 | 5.66% | 669 | (39) | -0.38% |
| Total borrowings | 36,933 | 1,079 | 3.91% | 104,536 | 2,028 | 2.59% | (67,603) | (949) | 1.32% |
| Total interest-bearing liabilities | <u>\$ 628,195</u> | <u>\$ 7,945</u> | 1.69% | <u>\$ 742,220</u> | <u>\$ 11,352</u> | 2.04% | <u>\$ (114,025)</u> | <u>\$ (3,407)</u> | -0.35% |
| Net interest income/spread | | <u>\$ 17,928</u> | 3.00% | | <u>\$ 22,351</u> | 3.41% | | <u>\$ (4,423)</u> | -0.41% |
| Net interest margin | | | 3.25% | | | 3.62% | | | -0.37% |
| Notation: | | | | | | | | | |
| Non-interest-bearing deposits | \$ 114,686 | - | - | \$ 73,137 | - | - | \$ 41,549 | - | (f) |
| Total deposits | <u>\$ 705,948</u> | <u>\$ 6,866</u> | 1.30% | <u>\$ 710,821</u> | <u>\$ 9,324</u> | 1.75% | <u>\$ (4,873)</u> | <u>\$ (2,458)</u> | -0.45% |
| Taxable equivalents: | | | | | | | | | |
| Total interest-earning assets | \$ 738,281 | \$ 25,918 | 4.69% | \$ 826,362 | \$ 33,899 | 5.48% | \$ (88,081) | \$ (7,981) | -0.79% |
| Net interest income/spread | - | \$ 17,973 | 3.00% | - | \$ 22,547 | 3.44% | - | \$ (4,574) | -0.44% |
| Net interest margin | - | - | 3.25% | - | - | 3.65% | - | - | -0.40% |

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

- (a) We elected to remain very liquid in 2010 and as a result the average balance of cash equivalents increased.
- (b) Taxable investments decreased due to sales and repayments. Tax exempt investments were sold during 2009 and therefore the average balance has declined. These investments were sold because tax exempt income was less important and because of concerns about the financial stability of issuers.
- (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) See Note 12 to the quarterly report for an explanation of the decrease. The amount of participating interest in mortgage loans will vary depending on the level of originations by counterparties.
- (e) The balance of loans has declined due to repayments, sales, foreclosures and charge-offs.
- (f) Checking and money market accounts have grown due to the success of a new initiative designed to grow deposits.
- (g) In 2010, the balances of certificates have declined as we have been focusing on reducing the cost of funds.
- (h) The increase in non-interest bearing deposits has reduced the need for short-term borrowings.
- (i) 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 | | | | Nine Months Ended | | | |
|-----------------------------------|--------------------|-----------------|---------------------|-------------|-------------------|------------------|---------------------|-------------|
| | September 30, | | Increase (Decrease) | | September 30, | | Increase (Decrease) | |
| | 2010 | 2009 | \$ | % | 2010 | 2009 | \$ | % |
| Bank charges and service fees | \$ 629 | \$ 562 | \$ 67 | 12 % | \$ 1,828 | \$ 1,662 | \$ 166 | 10 % |
| Wealth management revenues | 612 | 433 | 179 | 41 % | 1,773 | 1,512 | 261 | 17 % (a) |
| Mortgage banking revenues | 3,248 | 2,163 | 1,085 | 50 % | 8,262 | 5,655 | 2,607 | 46 % (b) |
| Gains on sales of loans, net | 212 | 2 | 210 | 10,500 % | 212 | 88 | 124 | 141 % (c) |
| Gains on sales of securities, net | 517 | 153 | 364 | 238 % | 4,390 | 2,024 | 2,366 | 117 % (c) |
| Other | 385 | 175 | 210 | 120 % | 984 | 588 | 396 | 67 % (d) |
| Total non-interest income | \$ 5,603 | \$ 3,488 | \$ 2,115 | 61 % | \$ 17,449 | \$ 11,529 | \$ 5,920 | 51 % |

- (a) Wealth management revenues are expected to decrease in 2011 as we are exiting the ESOP trustee practice and custodial fees we receive for certain insurance products are expected to decline.
- (b) Mortgage banking revenues increased because low mortgage rates are also conducive to originating loans.
- (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) Increase in the first nine months of 2010 is due to gains related to the sale of a branch.

Non-interest Expense

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

| | Three Months Ended | | | | Nine Months Ended | | | |
|---|--------------------|------------------|---------------------|---------------|-------------------|------------------|---------------------|-------------|
| | September 30, | | Increase (Decrease) | | September 30, | | Increase (Decrease) | |
| | 2010 | 2009 | \$ | % | 2010 | 2009 | \$ | % |
| Salaries and employee benefits | \$ 3,774 | \$ 3,803 | \$ (29) | (1) % | \$ 11,767 | \$ 11,238 | \$ 529 | 5 % (a) |
| Professional services | 1,354 | 667 | 687 | 103 % | 3,472 | 1,936 | 1,536 | 79 % (b) |
| Other real estate costs | 1,098 | 4,701 | (3,603) | (77) % | 1,830 | 7,281 | (5,451) | (75) % (c) |
| Data processing fees | 737 | 607 | 130 | 21 % | 2,005 | 1,681 | 324 | 19 % |
| Occupancy | 734 | 617 | 117 | 19 % | 2,162 | 1,886 | 276 | 15 % (d) |
| Regulatory costs | 599 | 323 | 276 | 85 % | 1,427 | 1,101 | 326 | 30 % (e) |
| Depreciation and amortization | 336 | 402 | (66) | (16) % | 989 | 1,132 | (143) | (13) % |
| Marketing and promotion | 329 | 360 | (31) | (9) % | 1,003 | 866 | 137 | 16 % (f) |
| Office supplies and postage | 138 | 144 | (6) | (4) % | 444 | 442 | 2 | 0 % |
| Fraud loss on assets serviced by others | - | - | - | 0 % | 26,231 | - | 26,231 | 100 % (g) |
| Other | 593 | 1,121 | (528) | (47) % | 1,818 | 2,632 | (814) | (31) % (h) |
| Total non-interest expense | \$ 9,692 | \$ 12,745 | \$ (3,053) | (24) % | \$ 53,148 | \$ 30,195 | \$ 22,953 | 76 % |
| Efficiency ratio | 85.2% | 112.4% | | | 150.2% | 89.1% | | |

- (a) Increases in compensation for the nine month period primarily relate to increases in mortgage banking personnel and merit increases for banking personnel. Staffing levels in mortgage banking were reviewed in the third quarter and compensation costs moderated as a result.
- (b) Professional services costs have increased due to mortgage banking activities and investigative costs related to the fraud loss on assets serviced by others.
- (c) Other real estate costs are lower as it has not been necessary to reduce carrying values of foreclosed properties as dramatically in 2010 when compared 2009.
- (d) The increase in occupancy costs is related to expanded mortgage banking operations.
- (e) Assessed rates on deposits have increased and in the second quarter of 2009 the FDIC implemented a special assessment for all banks.
- (f) Marketing costs increased due to promotions for depository products and mortgage banking.
- (g) See Note 12 to the quarterly report.
- (h) In the third quarter of 2009 we took an impairment charge related to intangible asset of \$409 thousand

Income Taxes

Tax expense of \$0 was recognized in the third quarter of 2010 as the Company has net operating loss carryforwards for federal and state tax purposes. A tax benefit of \$1.814 million, or 7.7% of the pre-tax loss, was recognized in the third quarter of 2009.

Comparison of Financial Condition at September 30, 2010 and December 31, 2009

Assets

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

| | September 30, | December 31, | Increase (Decrease) | |
|--|-------------------|-------------------|---------------------|------------|
| | 2010 | 2009 | \$ | % |
| Cash and cash equivalents | \$ 48,496 | \$ 35,362 | \$ 13,134 | 37 % |
| Investment securities available for sale | 150,322 | 212,661 | (62,339) | (29) % (a) |
| Federal Reserve Bank and Federal Home Loan Bank of Des Moines stock | 2,862 | 3,048 | (186) | (6) % |
| Loans held for sale | 50,691 | 24,130 | 26,561 | 110 % (b) |
| Participating interests in mortgage loans | 12,943 | 38,534 | (25,591) | (66) % (c) |
| Loans and leases held for investment, net | 428,969 | 499,061 | (70,092) | (14) % (d) |
| Other real estate, net | 10,571 | 7,253 | 3,318 | 46 % (e) |
| Premises and equipment, net | 19,519 | 20,422 | (903) | (4) % |
| Interest receivable | 2,342 | 2,970 | (628) | (21) % |
| Other assets | 22,276 | 24,642 | (2,366) | (10) % (f) |
| Total assets | <u>\$ 748,991</u> | <u>\$ 868,083</u> | <u>\$ (119,092)</u> | (14) % |

- (a) Investments have decreased due to sales and repayments.
- (b) The balance of loans held for sale can vary depending on the volume of loans originated and efficiency with which the loans are sold.
- (c) The amount of participating interests in mortgage loans will vary depending on the level of originations by counterparties. See Note 12 to the quarterly report.
- (d) The balance of loans has declined due to repayments, sales and charge-offs.
- (e) Other real estate increased as we have pursued foreclosure for certain problem loans.
- (f) Other assets decreased due to the receipt of tax refunds related to loss carry back periods.

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):

| | September 30, 2010 | | December 31, 2009 | | Increase (Decrease) | |
|--|--------------------|-------|-------------------|-------|---------------------|------------|
| | Amount | % | Amount | % | Amount | % |
| Commercial and industrial | \$ 95,283 | 21.6 | \$ 124,773 | 23.2 | \$ (29,490) | (24) % (a) |
| Real estate mortgage | 276,147 | 62.5 | 266,051 | 49.5 | 10,096 | 4 % (a) |
| Real estate construction | 48,222 | 10.9 | 96,327 | 17.9 | (48,105) | (50) % (a) |
| Participating interests in mortgage loans | 12,943 | 2.9 | 38,534 | 7.2 | (25,591) | (66) % (b) |
| Agricultural | 19,387 | 4.4 | 23,142 | 4.3 | (3,755) | (16) % |
| Other | 7,076 | 1.6 | 7,397 | 1.4 | (321) | (4) % |
| Total principal amount of loans | 459,058 | 103.9 | 556,224 | 103.5 | (97,166) | (17) % |
| Unearned income and net unamortized deferred fees and costs | (389) | (0.1) | (582) | (0.1) | 193 | (33) % |
| Loans, net of unearned income and unamortized fees and costs | 458,669 | 103.8 | 555,642 | 103.4 | (96,973) | (17) % |
| Less allowance for credit losses | (16,757) | (3.8) | (18,047) | (3.4) | 1,290 | (7) % (c) |
| Net loans | \$ 441,912 | 100.0 | \$ 537,595 | 100.0 | \$ (95,683) | (18) % |

- (a) On an overall basis loans have decreased due to repayments and foreclosure activity. Construction loans decreased because construction projects have been completed and reclassified to real estate mortgage loans.
- (b) Participating interest in mortgage loans will vary depending on the activity of our counterparties. See Note 12 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 \$312.1 million as of September 30, 2010 and \$330.2 million as of December 31, 2009.

Concentrations of Credit

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

| | September 30, 2010 | | | December 31, 2009 | | |
|--------------|--------------------|-----|---|-------------------|-----|---|
| | Amount | % | | Amount | % | |
| North Dakota | \$ 180,476 | 39 | % | \$ 199,831 | 36 | % |
| Minnesota | 131,781 | 29 | | 154,007 | 28 | |
| Arizona | 82,336 | 18 | | 125,579 | 22 | |
| Other | 64,465 | 14 | | 76,807 | 14 | |
| Totals | \$ 459,058 | 100 | % | \$ 556,224 | 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):

| | September 30, 2010 | | | December 31, 2009 | | |
|--------------|---------------------------|----------------|--------------|--------------------------|----------------|--------------|
| North Dakota | \$ | 165,537 | 36 % | \$ | 184,282 | 33 % |
| Arizona | | 98,199 | 21 | | 134,967 | 24 |
| Minnesota | | 63,278 | 14 | | 81,514 | 15 |
| California | | 32,237 | 7 | | 39,848 | 7 |
| Texas | | 27,083 | 6 | | 28,944 | 5 |
| Kentucky | | 12,041 | 3 | | 11,927 | 2 |
| Wisconsin | | 9,449 | 2 | | 9,840 | 2 |
| Idaho | | 9,167 | 2 | | 9,292 | 2 |
| Georgia | | 6,360 | 1 | | 6,465 | 1 |
| New York | | 6,286 | 1 | | 5,270 | 1 |
| Arkansas | | 5,270 | 1 | | 5,199 | 1 |
| Other | | 24,151 | 6 | | 38,676 | 7 |
| Totals | \$ | <u>459,058</u> | <u>100 %</u> | \$ | <u>556,224</u> | <u>100 %</u> |

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

| | <u>September 30, 2010</u> | <u>December 31, 2009</u> |
|---|---------------------------|--------------------------|
| North Dakota | | |
| Commercial and industrial | \$ 75,681 | \$ 84,400 |
| Construction | 1,637 | 4,572 |
| Agricultural | 18,562 | 22,422 |
| Land and land development | 10,781 | 12,321 |
| Owner-occupied commercial real estate | 26,667 | 27,960 |
| Non-owner-occupied commercial real estate | 13,052 | 12,419 |
| Small business administration | 2,664 | 2,434 |
| Consumer/participating interests | 16,493 | 17,754 |
| Subtotal | <u>\$ 165,537</u> | <u>\$ 184,282</u> |
| Arizona | | |
| Commercial and industrial | \$ 11,426 | \$ 19,740 |
| Construction | - | 2,136 |
| Agricultural | - | - |
| Land and land development | 10,610 | 18,541 |
| Owner-occupied commercial real estate | 19,604 | 23,508 |
| Non-owner-occupied commercial real estate | 33,136 | 32,497 |
| Small business administration | 5,532 | 5,042 |
| Consumer/participating interests | 17,891 | 33,503 |
| Subtotal | <u>\$ 98,199</u> | <u>\$ 134,967</u> |
| Minnesota | | |
| Commercial and industrial | \$ 3,515 | \$ 10,589 |
| Construction | 1,975 | 4,698 |
| Agricultural | 31 | 33 |
| Land and land development | 11,505 | 12,641 |
| Owner-occupied commercial real estate | 17,231 | 18,675 |
| Non-owner-occupied commercial real estate | 21,383 | 25,203 |
| Small business administration | 873 | 1,025 |
| Consumer/participating interests | 6,765 | 8,650 |
| Subtotal | <u>\$ 63,278</u> | <u>\$ 81,514</u> |

Loan Maturities (1)

The following table sets forth the remaining maturities of loans in each major category of our portfolio as of September 30, 2010 (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 | \$ 45,364 | \$ 25,845 | \$ 7,236 | \$ 11,801 | \$ 5,037 | \$ 95,283 |
| Real estate mortgage | 66,710 | 94,319 | 54,339 | 24,452 | 36,327 | 26,147 |
| Real estate construction | 26,208 | 7,556 | 12,096 | 61 | 2,301 | 48,222 |
| Participating interests in mortgage loans | 8,494 | 6,723 | 478 | 664 | 3,028 | 19,387 |
| Agricultural | 2,369 | 3,595 | 350 | 147 | 615 | 7,076 |
| Other | 12,943 | - | - | - | - | 12,943 |
| Total principal amount of loans | \$ 162,088 | \$ 138,038 | \$ 74,499 | \$ 37,125 | \$ 47,308 | \$ 459,058 |

(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 | | Nine Months Ended | |
|--|--------------------|------------------|-------------------|------------------|
| | September 30, | | September 30, | |
| | 2010 | 2009 | 2010 | 2009 |
| Balance, beginning of period | \$ 18,170 | \$ 10,339 | \$ 18,047 | \$ 8,751 |
| Provision for credit losses | 1,250 | 22,300 | 4,750 | 26,000 |
| Loans charged off | (2,995) | (11,665) | (6,408) | (13,935) |
| Loans recovered | 332 | 14 | 368 | 172 |
| Balance, end of period | \$ 16,757 | \$ 20,988 | \$ 16,757 | \$ 20,988 |
| Total loans | \$ 509,360 | \$ 600,728 | | |
| Loans and leases held for investment | \$ 445,726 | \$ 545,603 | | |
| Allowance for credit losses as a percentage of total loans | 3.29% | 3.49% | | |
| Allowance for credit losses as a percentage of loans and leases held for investment | 3.76% | 3.85% | | |

| | Three Months | | Nine Months | |
|--|---------------------|----------|---------------------|----------|
| | Ended September 30, | | Ended September 30, | |
| | 2010 | 2009 | 2010 | 2009 |
| Ratio of net charge-offs to average total loans | (0.516)% | (1.926)% | (1.121)% | (2.287)% |
| Ratio of net charge-offs to average loans and leases held for investment | (0.571)% | (2.104)% | (1.228)% | (2.502)% |
| Ratio of net charge-offs to average total loans, annualized | (2.064)% | (7.705)% | (1.495)% | (3.049)% |
| Ratio of net charge-offs to average loans and leases held for investment, annualized | (2.285)% | (8.416)% | (1.637)% | (3.336)% |

The provision for credit losses was \$1.250 million in the third quarter of 2010 and \$22.300 million in the third quarter of 2009.

The following table summarizes activity and other information related to the allowance for credit losses as of September 30 (in thousands):

| | Three Months Ended | | Nine Months Ended | |
|--|--------------------|------------|-------------------|------------|
| | September 30, | | September 30, | |
| | 2010 | 2009 | 2010 | 2009 |
| Balance of allowance for credit losses, beginning of period | \$ 18,170 | \$ 10,339 | \$ 18,047 | \$ 6,599 |
| Charge-offs: | | | | |
| Commercial and industrial | (2,293) | (1,791) | (3,058) | (738) |
| Real estate mortgage | (248) | (1,675) | (449) | (359) |
| Real estate construction | (384) | (8,185) | (2,824) | (1,930) |
| Agricultural | - | - | - | - |
| Other | (70) | (14) | (77) | (24) |
| Total charge-offs | (2,995) | (11,665) | (6,408) | (3,051) |
| Recoveries: | | | | |
| Commercial and industrial | 1 | 12 | 20 | 34 |
| Real estate mortgage | 309 | - | 309 | - |
| Real estate construction | 21 | - | 30 | 195 |
| Agricultural | - | - | - | - |
| Other | 1 | 2 | 9 | 18 |
| Total recoveries | 332 | 14 | 368 | 247 |
| Net charge-offs | (2,663) | (11,651) | (6,040) | (2,804) |
| Provision for credit losses charged to operations | 1,250 | 22,300 | 4,750 | 4,600 |
| Balance of allowance for credit losses, end of period | \$ 16,757 | \$ 20,988 | \$ 16,757 | \$ 8,395 |
| Ratio of net charge-offs to average total loans | (0.516)% | (1.926)% | (1.121)% | (0.514)% |
| Ratio of net charge-offs to average loans and leases held for investment | (0.571)% | (2.104)% | (1.228)% | (0.541)% |
| Average gross loans and leases held for investment | \$ 466,209 | \$ 553,747 | \$ 491,843 | \$ 518,037 |
| Ratio of allowance for credit losses to loans and leases held for investment | 3.76% | 3.85% | | |
| Ratio of allowance for credit losses to nonperforming loans | 74% | 57% | | |

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

| | September 30, 2010 | | December 31, 2009 | |
|---|------------------------|--|------------------------|--|
| | 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 | \$ 1,648 | 21% | \$ 5,779 | 23% |
| Real estate mortgage | 12,304 | 60% | 6,672 | 48% |
| Real estate construction | 2,398 | 10% | 4,692 | 17% |
| Participating interests in mortgage loans | 38 | 3% | 105 | 7% |
| Agricultural | 273 | 4% | 704 | 4% |
| Other | 96 | 2% | \$ 95 | 1% |
| Total | <u>\$ 16,757</u> | <u>100%</u> | <u>\$ 18,047</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 September 30, 2010 | | Nine Months Ended September 30, 2010 | |
|--|--|--|---|--|
| | | | | |
| Balance, beginning of period | \$ 24,682 | | \$ 35,890 | |
| Additions to nonperforming | 320 | | 5,066 | |
| Charge-offs | (632) | | (3,266) | |
| Reclassified back to performing | - | | (4,111) | |
| Principal payments received | (815) | | (4,259) | |
| Transferred to other real estate owned | (829) | | (6,594) | |
| Balance, end of period | <u>\$ 22,726</u> | | <u>\$ 22,726</u> | |

Nonperforming Assets

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

| | <u>September 30,</u> <u>2010</u> | <u>December 31,</u> <u>2009</u> |
|--|-------------------------------------|------------------------------------|
| Nonperforming loans: | | |
| Loans 90 days or more delinquent and still accruing interest | \$ 1 | \$ 1 |
| Non-accrual loans | 22,725 | 35,889 |
| Total nonperforming loans | <u>22,726</u> | <u>35,890</u> |
| Other real estate, net | 10,571 | 7,253 |
| Total nonperforming assets | <u>\$ 33,297</u> | <u>\$ 43,143</u> |
| Allowance for credit losses | <u>\$ 16,757</u> | <u>\$ 18,047</u> |
| Ratio of total nonperforming loans to total loans | 4.46% | 6.19% |
| Ratio of total nonperforming loans to loans and leases held for investment | 5.10% | 6.94% |
| Ratio of total nonperforming assets to total assets | 4.45% | 4.97% |
| Ratio of allowance for credit losses to nonperforming loans | 74% | 50% |

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 September 30, 2010 the Bank had \$52.4 million of classified loans and \$22.7 million of loans on non-accrual. This compares to \$54.2 million of classified loans and \$35.9 million of loans on non-accrual at December 31, 2009.

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):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---------------|--|-----------------|
| | 2010 | 2009 | 2010 | 2009 |
| Interest income that would have been recorded | \$ 304 | \$ 468 | \$ 834 | \$ 1,049 |
| Interest income recorded | - | - | - | 32 |
| Effect on interest income | <u>\$ 304</u> | <u>\$ 468</u> | <u>\$ 834</u> | <u>\$ 1,017</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):

| | September 30, 2010 | | December 31, 2009 | |
|---------------------------------|----------------------------|----------------------------|----------------------------|----------------------------|
| | Recorded Investment | Valuation Allowance | Recorded Investment | Valuation Allowance |
| Valuation allowance required | \$ 36,367 | \$ 5,732 | \$ 33,821 | \$ 3,998 |
| No valuation allowance required | 400 | - | 2,377 | - |
| Total impaired loans | <u>\$ 36,767</u> | <u>\$ 5,732</u> | <u>\$ 36,198</u> | <u>\$ 3,998</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):

| | September 30, 2010 | September 30, 2009 |
|--|--|--|
| Average recorded investment in impaired loans | \$ 38,950 | \$ 41,126 |
| Average recorded investment in impaired loans as a percentage of average total loans | <u>7.23%</u> | <u>6.83%</u> |
| | Three Months Ended September 30, 2010 | Three Months Ended September 30, 2009 |
| Interest income recognized on impaired loans | \$ 128 | \$ - |
| Interest income recognized on a cash basis during the time of impairment | <u>\$ -</u> | <u>\$ -</u> |
| | Nine Months Ended September 30, 2010 | Nine Months Ended September 30, 2009 |
| Interest income recognized on impaired loans | \$ 179 | \$ 32 |
| Interest income recognized on a cash basis during the time of impairment | <u>\$ -</u> | <u>\$ 1</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 \$38.2 million at September 30, 2010 and \$14.3 million at December 31, 2009.

Potential Problem Loans

We attempt to quantify potential problem loans with more immediate exposure and at September 30, 2010 such loans totaled \$12.8 million compared to \$22.0 million at December 31, 2009. 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 5 included in the quarterly report.

Liabilities

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

| Liabilities | September 30, | December 31, | Increase (Decrease) | | |
|--|---------------|--------------|---------------------|-------|-------|
| | 2010 | 2009 | \$ | % | |
| Deposits: | | | | | |
| Non-interest-bearing | \$ 114,050 | \$ 98,658 | \$ 15,392 | 16 | % (a) |
| Interest-bearing - | | | | | |
| Savings, interest checking and money market | 290,711 | 280,571 | 10,140 | 4 | % (a) |
| Time deposits \$100,000 and over | 43,391 | 52,222 | (8,831) | (17) | % (b) |
| Other time deposits | 213,777 | 324,512 | (110,735) | (34) | % (b) |
| Short-term borrowings | 14,642 | 10,190 | 4,452 | 44 | % |
| Federal Home Loan Bank advances | - | 15,000 | (15,000) | (100) | % (c) |
| Other borrowings | - | - | - | - | % |
| Guaranteed preferred beneficial interests in Company's subordinated debentures | 23,811 | 22,890 | 921 | 4 | % |
| Accrued interest payable | 1,098 | 1,468 | (370) | (25) | % |
| Accrued expenses | 5,712 | 2,946 | 2,766 | 94 | % (d) |
| Other liabilities | 5,221 | 2,361 | 2,860 | 121 | % (e) |
| Total liabilities | \$ 712,413 | \$ 810,818 | \$ (98,405) | (12) | % |

- (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) Certificates of deposits have decreased as we have focused on increasing lower cost deposits.

- (c) FHLB advances are lower because we have funded assets using deposits. Available borrowing capacity from the FHLB was in excess of \$76.1 million at September 30, 2010.
- (d) The increase is related to dividends on preferred stock and other miscellaneous liabilities.
- (e) Other liabilities have increased due to the fair value adjustment of forward sales commitments.

Stockholders' Equity

Our stockholders' equity decreased \$20.7 million between December 31, 2009 and September 30, 2010. Equity decreased due to the fraud loss on assets serviced by others – see Note 12.

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, which affords it the opportunity to borrow funds in terms ranging from overnight to 10 years and beyond. 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 \$76.1 million as of September 30, 2010.

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 September 30, 2010 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 September 30, 2010 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 September 30, 2010, 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):

| Net Interest Income Simulation | | | | | | |
|---|---------------|------------------|---------------|---------------|---------------|---------------|
| 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 | \$ 23,796 | \$ 23,891 | \$ 24,361 | \$ 24,899 | \$ 24,981 | 24,921 |
| Dollar change from unchanged scenario | \$ (95) | - | \$ 470 | \$ 1,008 | \$ 1,090 | \$ 1,030 |
| Percentage change from unchanged scenario | (0.40)% | - | 1.97% | 4.22% | 4.56% | 4.31% |
| Policy guidelines (decline limited to) | (5.00)% | - | (5.00)% | (10.00)% | (15.00)% | (20.00)% |

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 September 30, 2010 (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 September 30, 2010. 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 September 30, 2010

| | <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) | | | | |
| Interest-earning assets: | | | | | |
| Interest-bearing deposits with banks | \$ 48,496 | \$ - | \$ - | \$ - | \$ 48,496 |
| Investment securities | 15,756 | 44,154 | 72,748 | 17,664 | 150,322 |
| FRB and FHLB stock | 2,862 | - | - | - | 2,862 |
| Fed funds sold | - | - | - | - | - |
| Loans held for sale, fixed rate | - | 50,691 | - | - | 50,691 |
| Loans held for sale, floating rate | - | - | - | - | - |
| Loans held for investment, fixed rate | 39,592 | 58,026 | 108,064 | 16,953 | 222,635 |
| Loans held for investment, floating rate | 209,284 | 3,865 | 22,885 | - | 236,034 |
| Total interest-earning assets | <u>\$ 315,990</u> | <u>\$ 156,736</u> | <u>\$ 203,697</u> | <u>\$ 34,617</u> | <u>\$ 711,040</u> |
| Interest-bearing liabilities: | | | | | |
| Interest checking and money market accounts | \$ 279,601 | \$ - | \$ - | \$ - | \$ 279,601 |
| Savings | 11,110 | - | - | - | 11,110 |
| Time deposits under \$100,000 | 50,773 | 57,013 | 51,479 | 54,512 | 213,777 |
| Time deposits \$100,000 and over | 11,021 | 22,632 | 9,738 | - | 43,391 |
| Short-term borrowings | 14,642 | - | - | - | 14,642 |
| FHLB advances | - | - | - | - | - |
| Other borrowing | - | - | - | - | - |
| Subordinated debentures | 15,000 | - | - | 8,811 | 23,811 |
| Total interest-bearing liabilities | <u>\$ 382,147</u> | <u>\$ 79,645</u> | <u>\$ 61,217</u> | <u>\$ 63,323</u> | <u>\$ 586,332</u> |
| Interest rate gap | <u>\$ (66,157)</u> | <u>\$ 77,091</u> | <u>\$ 142,480</u> | <u>\$ (28,706)</u> | <u>\$ 124,708</u> |
| Cumulative interest rate gap at September 30, 2010 | <u>\$ (66,157)</u> | <u>\$ 10,934</u> | <u>\$ 153,414</u> | <u>\$ 124,708</u> | |
| Cumulative interest rate gap to total assets | (8.83%) | 1.46% | 20.48% | 16.65% | |

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 September 30, 2010 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.

Signatures

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

BNCCORP, INC.

Date: November 9, 2010

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

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