

## Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

### Overview

The following table summarizes net income and basic and diluted earnings per share for the 12 months ended December 31 (dollars are in thousands):

	<u>2007</u>	<u>2006</u>
Net income (loss) attributable to continuing operations	\$ (3,069)	\$ 1,018
Net income attributable to discontinued operations	<u>5,049</u>	<u>2,603</u>
Net income attributable to common shareholders	<u>\$ 1,980</u>	<u>\$ 3,621</u>
Net income per share		
Basic earnings (loss) per share from continuing operations	\$ (0.89)	\$ 0.29
Basic earnings per share from discontinued operations	\$ 1.46	\$ 0.75
Basic earnings per share	\$ 0.57	\$ 1.04
Diluted earnings (loss) per share from continuing operations	\$ (0.89)	\$ 0.29
Diluted earnings per share from discontinued operations	\$ 1.46	\$ 0.74
Diluted earnings per share	\$ 0.57	\$ 1.03

**Highlights.** The following information highlights key developments occurring in 2007:

- Sale of BNC Insurance resulted in the following:
  - pre-tax gain of approximately \$6.083 million,
  - significantly reduced intangible assets,
  - increased liquidity, and;
  - increased regulatory capital;
- Investment securities were sold and FHLB advances were prepaid to improve net interest margin;
- Subordinated debentures aggregating \$15 million were refinanced to a lower adjustable rate of Libor plus 1.40%;
- Loans and leases held for investment increased \$163.6 million to \$497.6 million;
- Net interest income increased approximately 18.3% to \$22.247 million;
- Net interest margin increased to 3.81% from 3.04%;
- Non-interest income, excluding losses from sales of securities, increased to \$7.130 million from \$5.223 million, or 36.5%;
- Non-interest expense, excluding debt extinguishment costs and amounts awarded to one of the founders of BNC upon retirement, increased by \$1.188 million, or 5.1%;
- Wealth management revenues grew to \$2.041 million, or 87.1%;
- Assets under administration increased to \$358.6, an increase of 26.8%;
- Custodial Trust accounts increased to 362 accounts on December 31, 2007 from 16 accounts on December 31, 2006.

### Results from Continuing Operations

The net loss from continuing operations in 2007 was \$(3.069) million, or \$(0.89) per diluted share, compared to net income of \$1.018 million, or \$0.29 per diluted share in 2006.

### Net Interest Income in Continuing Operations

The following table sets forth information relating to our average balance sheet and reflects the yield on average assets and cost of average liabilities. Such yields and costs are derived by dividing income and expense by the

average balance of assets and liabilities. All average balances have been derived from monthly averages, which are indicative of daily averages (dollars are in thousands):

### Analysis of Changes in Net Interest Income

	For the Year ended December 31,			For the Year ended December 31,			For the Year ended December 31,		
	2007			2006			2005		
	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
	(dollars are in thousands)			(dollars are in thousands)			(dollars are in thousands)		
<b>Assets</b>									
Federal funds sold/interest-bearing due from	\$ 14,616	\$ 754	5.16%	\$ 42,121	\$ 2,069	4.91%	\$ 8,068	\$ 304	3.77%
Taxable investments	124,242	6,001	4.83%	174,995	8,044	4.60%	192,990	7,949	4.12%
Tax-exempt investments	18,815	926	4.92%	36,249	1,644	4.54%	43,494	1,942	4.46%
Loans held for sale	417	-	0.00%	1,088	-	0.00%	20,073	738	3.68%
Participating interests in mortgage loans	27,469	2,137	7.78%	33,180	2,344	7.06%	63,493	3,814	6.01%
Loans and leases held for investment	402,616	34,423	8.55%	334,058	28,307	8.47%	305,074	22,517	7.38%
Allowance for credit losses	(4,335)	-		(3,326)	-		(3,377)	-	
Total interest-earning assets	583,840	44,241	7.58%	618,365	42,408	6.86%	629,815	37,264	5.92%
Non-interest-earning assets:									
Assets from discontinued operations	13,344			31,129			30,888		
Cash and due from banks	12,468			15,360			15,823		
Other	41,653			40,004			37,356		
Total assets	\$ 651,305			\$ 704,858			\$ 713,882		
<b>Liabilities and Stockholders' Equity</b>									
Deposits:									
Interest checking and money market accounts	\$ 249,246	8,007	3.21%	\$ 246,476	7,440	3.02%	\$ 236,832	5,036	2.13%
Savings	8,399	66	0.79%	8,398	66	0.79%	7,935	63	0.79%
Time deposits:									
Under \$100,000	149,010	7,141	4.79%	150,194	6,440	4.29%	114,157	3,547	3.11%
\$100,000 and over	44,824	2,319	5.17%	54,155	2,499	4.61%	79,977	3,196	4.00%
Total interest-bearing deposits	451,479	17,533	3.88%	459,223	16,445	3.58%	438,901	11,842	2.70%
Borrowings:									
Short-term borrowings	8,706	398	4.57%	14,480	685	4.73%	24,001	757	3.15%
FHLB advances	32,991	1,915	5.80%	73,060	4,020	5.50%	96,997	4,613	4.76%
Long-term borrowings	131	11	8.40%	2,659	201	7.56%	8,316	468	5.63%
Subordinated debentures	22,641	2,137	9.44%	22,458	2,255	10.04%	22,358	2,036	9.11%
Total interest-bearing liabilities	515,948	21,994	6.92%	571,880	23,606	4.13%	590,573	19,716	3.34%
Non-interest-bearing demand accounts	68,277			68,743			65,707		
Total deposits and interest-bearing liabilities	584,225			640,623			656,280		
Liabilities from discontinued operations	2,584			6,062			6,281		
Other non-interest-bearing liabilities	6,089			5,161			4,851		
Total liabilities	592,898			651,846			667,412		
Stockholders' equity	58,407			53,012			46,470		
Total liabilities and stockholders' equity	\$ 651,305			\$ 704,858			\$ 713,882		
Net interest income		\$ 22,247			\$ 18,802			\$ 17,548	
Net interest spread			3.32%			2.73%			2.58%
Net interest margin			3.81%			3.04%			2.79%
Ratio of average interest-earning assets to average interest-bearing liabilities	113.16%			108.13%			106.64%		

The following table illustrates the dollar amount of changes in our interest income and interest expense for the major components of interest-earning assets and interest-bearing liabilities and distinguishes between the changes related to volume and rates (changes attributable to the combined impact of volume and rate have been allocated proportionately):

	<u>For the Year Ended December 31,</u>			<u>For the Year Ended December 31,</u>		
	<u>2007 Compared to 2006</u>			<u>2006 Compared to 2005</u>		
	<u>Change Due to</u>			<u>Change Due to</u>		
	<u>Volume</u>	<u>Rate</u>	<u>Total</u>	<u>Volume</u>	<u>Rate</u>	<u>Total</u>
	<u>(in thousands)</u>			<u>(in thousands)</u>		
<b>Interest Earned on Interest-Earning Assets</b>						
Federal funds sold/interest-bearing due from	\$ (1,425)	\$ 110	\$ (1,315)	\$ 1,647	\$ 118	\$ 1,765
Taxable investments	(2,477)	434	(2,043)	(389)	484	95
Tax-exempt investments	(873)	155	(718)	(329)	31	(298)
Loans held for sale	-	-	-	(359)	(379)	(738)
Participating interests in mortgage loans	(503)	296	(207)	(2,329)	859	(1,470)
Loans held for investment	<u>5,859</u>	<u>257</u>	<u>6,116</u>	<u>2,263</u>	<u>3,527</u>	<u>5,790</u>
Total increase in interest income	<u>581</u>	<u>1,252</u>	<u>1,833</u>	<u>504</u>	<u>4,640</u>	<u>5,144</u>
<b>Interest Expense on Interest-Bearing Liabilities</b>						
Interest checking and money market accounts	84	483	567	213	2,190	2,403
Savings	-	-	-	4	(1)	3
Time deposits:						
Under \$100,000	(50)	751	701	1,313	1,580	2,893
\$100,000 and over	(606)	426	(180)	(1,339)	642	(697)
Short-term borrowings	(265)	(22)	(287)	277	(349)	(72)
FHLB advances	(2,339)	234	(2,105)	(1,629)	1,036	(593)
Long-term borrowings	(215)	25	(190)	(539)	272	(267)
Subordinated debentures	<u>19</u>	<u>(137)</u>	<u>(118)</u>	<u>9</u>	<u>210</u>	<u>219</u>
Total increase (decrease) in interest expense	<u>(3,372)</u>	<u>1,760</u>	<u>(1,612)</u>	<u>(1,691)</u>	<u>5,580</u>	<u>3,889</u>
Increase (decrease) in net interest income	<u>\$ 3,953</u>	<u>\$ (508)</u>	<u>\$ 3,445</u>	<u>\$ 2,195</u>	<u>\$ (940)</u>	<u>\$ 1,255</u>

Net interest income was \$22.247 million in 2007 compared to \$18.802 million in 2006, an increase of \$3.445 million or 18.3%. The net interest margin increased to 3.81% for the year ended December 31, 2007, from 3.04% in 2006.

Interest income increased in 2007 primarily due to higher balances of loans and leases held for investment. These balances were higher due to purchases of loans aggregating \$70.0 million and organic loan growth. A significant portion of loan purchases related to loan participations we had previously sold, which we were able to repurchase when our lending limit increased after the sale of BNC Insurance. The increase in interest income resulting from the

increase in loans and leases held for investment was partially offset by a decrease in investment securities and Federal Funds sold. Interest rates on all of our interest earning assets were higher in 2007 than in 2006.

Interest expense decreased in 2007 primarily because of lower balances of FHLB advances which we prepaid in the middle of the year. Interest rates paid on deposits increased in 2007 compared to 2006. We have attempted to grow deposits in our banking markets by paying competitive rates which support deposit growth.

Net interest income was \$18.802 million in 2006 compared to \$17.548 million in 2005, an increase of \$1.254 million or 7.15%. The net interest margin increased to 3.04% for the year ended December 31, 2006, from 2.79% in 2005.

Interest income increased in 2006 because of higher balances of loans and leases held for investment and Federal Funds sold. The increases in these balances were partially offset by the decreased balances of participating interests in mortgage loans which declined when the housing market softened. Interest income was positively impacted by interest rates which increased in 2006 because of the rising interest rate environment.

Interest expense increased in 2006 because of the rising interest rate environment. The impact of rising rates on liabilities was partially mitigated because we managed to reduce balances of FHLB advances and brokered deposits.

### Non-interest Income in Continuing Operations

Non-interest income decreased by \$1.285 million, or 25%, to \$3.853 million in 2007, compared to \$5.138 million in 2006. The following table presents the major categories of our non-interest income (dollars are in thousands):

#### Non-interest Income

	For the Years Ended December 31,		Increase ( Decrease)	
	2007	2006	2007 – 2006	
			\$	%
Bank charges and service fees	\$ 2,010	\$ 1,818	\$ 192	11 %
Wealth management revenues	2,041	1,091	950	87 % (a)
Gain on sales of loans	1,889	1,745	144	8 % (b)
Net loss on sales of securities	(3,277)	(84)	(3,193)	(3,801) % (c)
Other	1,190	568	622	110 % (d)
Total non-interest income	\$ 3,853	\$ 5,138	\$ (1,285)	(25) %

- (a) Wealth management revenues increased because assets under management increased. We also earned higher custodial fees for accumulating and maintaining documents related to insurance products sold by others. The volume of transactions for which we performed custodial services increased significantly in 2007.
- (b) Gains on sales of loans primarily relates to sales of commercial real estate loans. The gains can fluctuate significantly from period to period.
- (c) Gains and losses on sales of securities vary depending on the nature and volume of transactions. In 2007, we sold a relatively large volume of securities at a loss in order to improve net interest income in future periods.
- (d) Other income in 2007 was much higher than in 2006 primarily due to rent received for space formerly occupied by BNC Insurance. In the first quarter of 2007, we received a fee of approximately \$176,000 when we were taken out of a loan. This fee was recognized on a cash basis in non-interest income because we could not reasonably estimate when receipt would occur.

### Non-interest Expense in Continuing Operations

Non-interest expense increased by \$5.072 million, or 22%, to \$28.147 million in 2007 from \$23.075 million in 2006. The following table presents the major categories of our non-interest expense (dollars are in thousands):

## Non-interest Expense

	For the Years Ended December 31,		Increase (Decrease)	
			2007 – 2006	
	2007	2006	\$	%
Salaries and employee benefits	\$ 14,868	\$ 12,677	\$ 2,191	17 % (a)
Debt extinguishment costs	2,724	-	2,724	100 % (b)
Occupancy	2,146	2,349	(203)	(9) %
Depreciation and amortization	1,585	1,467	118	8 %
Professional services	1,198	1,014	184	18 %
Data processing	1,141	1,242	(101)	(8) %
Office supplies, telephone and postage	1,048	1,040	8	1 %
Marketing and promotion	703	865	(162)	(19) %
Correspondent charges	531	535	(4)	(1) %
FDIC and other assessments	228	198	30	15 %
Amortization of intangible assets	112	112	-	- %
Other	1,863	1,576	287	18 %
Total non-interest expense	<u>\$ 28,147</u>	<u>\$ 23,075</u>	<u>\$ 5,072</u>	22 %
Efficiency ratio	107.85%	96.39%	11.46%	

- (a) Compensation expense increased by \$1.160 million because one of the founders of BNC retired in 2007 and he was awarded bonuses. Compensation expense also increased because management bonuses were \$410 thousand in 2007 compared to \$0 in 2006. Employees were also granted merit increases.
- (b) Debt extinguishment costs were incurred in 2007 when FHLB advances were prepaid and subordinated debentures were refinanced. These costs were incurred in order to improve net interest margin in future periods.

### Income Tax Expense in Continuing Operations

We recorded income tax benefits of \$2.278 million and \$363 thousand for the years ended December 2007 and 2006, respectively. In 2007, the benefit primarily relates to losses on sales of securities, debt extinguishment costs incurred, the provision for credit losses and interest earned on tax exempt securities. In 2006, the benefit primarily relates to interest earned on tax exempt securities.

### Results from Discontinued Operations

Net income from discontinued operations in 2007 was \$5.049 million, or \$1.46 per diluted share, compared to net income of \$2.603 million, or \$0.74 per diluted share in 2006. The results of discontinued operations include a pre-tax gain on sale of \$6.083 million in 2007. In 2006 the pre-tax income from BNC Insurance was \$4.133 million. The effective tax rate was 37.8% in 2007 compared to 37.0% in 2006.

### Net Income in 2007 compared to 2006

Net income, which combines the results of continuing operations and discontinued operations, was \$1.980 million, or \$0.57 per diluted share, in 2007 compared to net income of \$3.621 million, or \$1.03 per diluted share, in 2006.

## Financial Condition

### Assets

Total assets were \$699.6 million at December 31, 2007 compared to \$692.3 million at December 31, 2006. The following table presents our assets by category as of December 31, 2007 and 2006 (dollars are in thousands):

## Assets

	As of December 31,		Increase (Decrease)	
	2007	2006	2007 – 2006	
	\$		\$	%
Cash and Cash Equivalents	\$ 14,856	\$ 18,216	\$ (3,360)	(18) %
Federal Funds Sold	-	24,000	(24,000)	100 % (a)
Investment securities available for sale	122,899	182,974	(60,075)	(33) % (b)
Federal Reserve Bank and Federal Home Loan Bank stock	4,918	5,003	(85)	(2) %
Loans held for sale	-	1,669	(1,669)	(100) %
Participating interests in mortgage loans	24,357	56,125	(31,768)	(57) % (c)
Loans and leases held for investment, net	490,957	330,564	160,393	49 % (d)
Premises and equipment, net	19,448	19,916	(468)	(2) %
Interest receivable	3,290	3,309	(19)	(1) %
Other assets	14,874	13,643	1,231	9 %
Intangible assets, net	409	521	(112)	(21) %
Assets from discontinued operations	11	32,680	(32,669)	(100) % (e)
Premises and equipment held for sale, net	3,572	3,656	(84)	(2)
Total assets	\$ 699,591	\$ 692,276	\$ 7,315	1 %

- (a) Federal Funds Sold decreased because yields on short term investments were relatively attractive at the end of 2006. In 2007, increases in loans and leases were partially financed by using Federal Funds Sold.
- (b) The balance of investments declined in 2007 because approximately \$59.5 million of investments were sold to finance the repayment of FHLB advances.
- (c) Participating interests in mortgage loans are collateralized by loans held for sale by mortgage banking counterparties. These balances will vary depending on the volume of loans originated by the counterparties. During 2007, the balance declined because one of our counterparties ceased operating.
- (d) In 2007, loans and leases have increased because we purchased loans, repurchased participations previously sold and funded organic growth. We have emphasized loan growth to grow net interest income.
- (e) Assets from discontinued operations declined due to the sale of substantially all of the assets of BNC Insurance.

### Investment Securities Available for Sale

Our investment policy is designed to enhance net income and return on equity through prudent management of risk, ensure liquidity for cash flow requirements, help manage interest rate risk, ensure collateral is available for public deposits, advances and repurchase agreements and manage asset diversification. In managing the portfolio, we seek a balance between current income (yield) and future market value volatility, while simultaneously managing credit and liquidity risks. The goal of this process is to maximize our longer term profitability as well as the economic performance of the portfolio over the long term.

The following table presents the composition of the available-for-sale investment portfolio by major category (in thousands):

## Investment Portfolio Composition

	December 31,					
	2007		2006		2005	
	Amortized cost	Estimated fair market value	Amortized cost	Estimated fair market value	Amortized cost	Estimated fair market value
U.S. government agency mortgage-backed securities guaranteed by GNMA	\$ 1,799	\$ 1,784	\$ 2,165	\$ 2,122	\$ 2,639	\$ 2,602
U.S. government agency mortgage-backed securities issued by FNMA	3,329	3,333	8,149	8,139	5,947	5,948
Collateralized mortgage obligations guaranteed by GNMA	2,394	2,413	9,533	9,370	7,592	7,429
Collateralized mortgage obligations issued by FNMA or FHLMC	62,384	63,306	148,119	144,477	168,473	164,234
Other collateralized mortgage obligations	32,830	33,079	-	-	-	-
State and municipal bonds	17,885	18,984	17,727	18,866	44,915	46,972
Total investments	<u>\$ 120,621</u>	<u>\$ 122,899</u>	<u>\$ 185,693</u>	<u>\$ 182,974</u>	<u>\$ 229,566</u>	<u>\$ 227,185</u>

The following table presents maturities for all securities available for sale (other than equity securities) and yields for all securities in our investment portfolio at December 31, 2007 (dollars are in thousands):

### Investment Portfolio - Maturity and Yields

	Within 1 year		After 1 but within 5 years		After 5 but within 10 years		After 10 years		Total	
	Amount	Yield <sup>(1)</sup>	Amount	Yield <sup>(1)</sup>	Amount	Yield <sup>(1)</sup>	Amount	Yield <sup>(1)</sup>	Amount	Yield <sup>(1)</sup>
U.S. government agency mortgage-backed securities guaranteed by GNMA (2) (3)	\$ -	0.00%	\$ 73	5.50%	\$ 384	6.54%	\$ 1,342	4.92%	\$ 1,799	5.29%
U.S. government agency mortgage-backed securities issued by FNMA (2) (3)	-	0.00%	-	0.00%	-	0.00%	3,329	5.91%	3,329	5.91%
Collateralized mortgage obligations guaranteed by GNMA (2) (3)	-	0.00%	-	0.00%	-	0.00%	2,394	5.25%	2,394	5.25%
Collateralized mortgage obligations issued by FNMA or FHLMC (2) (3)	-	0.00%	-	0.00%	17,310	4.70%	45,074	5.07%	62,384	4.97%
Other collateralized mortgage obligations (2) (3)	-	0.00%	-	0.00%	-	0.00%	32,830	5.46%	32,830	5.46%
State and municipal bonds (2)	<u>370</u>	8.11%	<u>3,806</u>	8.07%	<u>6,150</u>	7.56%	<u>7,559</u>	7.23%	<u>17,885</u>	7.54%
Total book value of investment securities	<u>\$ 370</u>	8.11%	<u>\$ 3,879</u>	8.02%	<u>\$ 23,844</u>	5.47%	<u>\$ 92,528</u>	5.42%	<u>\$ 120,621</u>	5.52%
Unrealized holding gain on securities available for sale									2,278	
Total investment in securities available for sale									<u>\$ 122,899</u>	5.42%

(1) Yields include adjustments for tax-exempt income.

(2) Based on amortized cost rather than fair value.

(3) Maturities of mortgage-backed securities and collateralized obligations are based on contractual maturities. Actual maturities may vary because obligors may have the right to call or prepay obligations with or without call or prepayment penalties.

As of December 31, 2007, we had \$122.9 million of available-for-sale securities in the investment portfolio as compared to \$183.0 and \$227.2 million at December 31, 2006 and 2005, respectively, based on fair value of the securities on those dates.

During 2007, investment securities declined because we sold approximately \$59.5 million of securities to finance repayment of \$62.0 million of FHLB advances. Unrealized gains in the investment portfolio have increased primarily because interest rates have declined. During 2007, \$3.277 million of net losses on sales of securities were realized. We elected to incur these losses in order to improve net interest income in future periods.

During 2006, available-for-sale securities decreased \$44.2 million compared to the end of 2005. The decrease in investment securities available-for-sale was the result of management's decision to use proceeds from the sales and maturities of investments to reduce higher cost borrowings. During 2006, \$84 thousand of net losses on sales of securities were realized.

At December 31, 2007, we held no securities of any single issuer, other than U.S. Government agency CMOs that exceeded 10% of stockholders' equity. A significant portion of our investment securities portfolio (approximately \$118.3 million at December 31, 2007) was pledged as collateral for public deposits and borrowings, including borrowings with the FHLB.

### Federal Reserve Bank and Federal Home Loan Bank Stock

Our equity securities consisted of \$1.3 million of Federal Reserve Bank ("FRB") stock as of December 31, 2007 and 2006, and \$3.6 and \$3.7 million of FHLB stock as of December 31, 2007 and 2006, respectively.

### Loan Portfolio

The following table presents the composition of our loan portfolio (dollars are in thousands):

	December 31,									
	2007		2006		2005		2004		2003	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Commercial and industrial	\$ 125,555	24.4	\$ 100,127	25.9	\$ 88,467	21.6	\$ 75,460	23.2	\$ 73,001	26.2
Real estate mortgage	181,000	35.1	124,551	32.2	122,785	30.1	129,321	39.8	129,198	46.4
Real estate construction	167,345	32.5	89,619	23.2	80,296	19.7	68,967	21.2	60,056	21.5
Agricultural	17,074	3.3	14,286	3.7	12,706	3.1	13,919	4.3	12,529	4.5
Consumer/other	5,878	1.1	4,237	1.1	4,718	1.2	5,480	1.7	6,277	2.3
Participating interests in mortgage loans	24,357	4.7	56,125	14.5	101,336	24.8	34,515	10.6	-	-
Lease financing	1,815	0.4	1,800	0.5	2,131	0.5	1,540	0.5	2,757	1.0
Total principal amount of loans	523,024	101.5	390,745	101.1	412,439	101.0	329,202	101.3	283,818	101.9
Unearned income and net unamortized deferred fees and costs	(1,111)	(0.2)	(686)	(0.2)	(735)	(0.2)	(873)	(0.3)	(508)	(0.2)
Loans, net of unearned income and unamortized fees and costs	521,913	101.3	390,059	100.9	411,704	100.8	328,329	101.0	283,310	101.7
Less allowance for credit losses	(6,599)	(1.3)	(3,370)	(0.9)	(3,188)	(0.8)	(3,335)	(1.0)	(4,763)	(1.7)
Net loans	\$ 515,314	100.0	\$ 386,689	100.0	\$ 408,516	100.0	\$ 324,994	100.0	\$ 278,547	100.0

## Change in Loan Portfolio Composition

	As of December 31,		Increase (Decrease)	
	2007	2006	2007 – 2006	
			\$	%
Commercial and industrial	\$ 125,555	\$ 100,127	\$ 25,428	25 % (a)
Real estate mortgage	181,000	124,551	56,449	45 % (b)
Real estate construction	167,345	89,619	77,726	87 % (b)
Agricultural	17,074	14,286	2,788	20 %
Consumer/other	5,878	4,237	1,641	39 %
Participating interests in mortgage loans	24,357	56,125	(31,768)	(57) % (c)
Lease financing	1,815	1,800	15	1 %
Total principal amount of loans	523,024	390,745	132,279	34 %
Unearned income and net unamortized deferred fees and costs	(1,111)	(686)	(425)	62 %
Loans, net of unearned income and unamortized deferred fees and costs	521,913	390,059	131,854	34 %
Less allowance for credit losses	(6,599)	(3,370)	(3,229)	96 %
Net loans	<u>\$ 515,314</u>	<u>\$ 386,689</u>	<u>\$ 128,625</u>	33 %

- (a) The increase in commercial and industrial loans is organic and is occurring in all markets (Arizona, Minnesota, North Dakota).
- (b) Real estate loans have increased because our lending limit increased significantly after the sale of BNC Insurance. As a result we were able to purchase loans, repurchase participations previously sold and increase investment in loans originated.
- (c) Participating interests in mortgage loans are collateralized mortgage loans held for sale by mortgage banking counterparties. These loans will vary significantly depending on the volume of originations by the counterparties. During 2007, the balance declined because one of our counterparties ceased operating.

Future loan growth potential is subject to volatility. A downturn in the economy could adversely impact our borrowers. This could, in turn, reduce the demand for loans and impact the borrowers' ability to repay their loans, while also decreasing our net interest margin. We cannot predict with any degree of certainty the full impact of current or future economic conditions on our ability to generate loan volume or the ultimate impact of economic conditions on our currently existing portfolio of loans. See "Factors That May Affect Future Results of Operations".

### Credit Policy, Underwriting, Approval and Review Procedures

We follow a uniform credit policy that sets forth underwriting and loan administration criteria. The Board of Directors (the "Board") establishes our loan policy, including lending guidelines for the various types of credit we offer based upon the recommendations of senior lending management. We have an Executive Credit Committee that approves loans over a certain size. Our loan policy is reviewed and reaffirmed by the Board at least annually.

We delegate lending decision authority among various lending officers and the Executive Credit Committee based on the size of the customer's credit relationship with BNC. All loans and commitments approved in excess of \$300,000 are presented to the Bank's Board of Directors on a quarterly basis for summary review. Any exceptions to loan policies and guidelines, to the extent the credit relationship amount exceeds individual loan officer lending authorities, are subject to special approval by the Bank's Chief Credit Officer or the appropriate credit committee.

Underwriting criteria are based upon the risks associated with each type of credit offered, the related borrowers and types of collateral. In underwriting commercial loans, we emphasize the borrower's earnings history, capitalization and secondary sources of repayment. In most instances, we require third party guarantees or highly liquid collateral.

Our credit administration function includes an internal loan review department that reviews established levels of our loan portfolio on a continuous basis. Loan review personnel are not involved in any way in the credit underwriting or approval process. Additionally, our lenders, loan review staff, Chief Credit Officer, Executive Credit Committee and various management team members review credit-related information monthly. Such information includes, but may

not be limited to, delinquencies, classified and nonperforming assets, and other information. Such reviews are conducted in order to evaluate credit risk within our credit portfolio and to review and establish the adequacy of the allowance for credit losses.

### Loan Participations

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

The Bank generally retains the right to service the loans as well as the right to receive a portion of the interest income on the loans. Loan participations sold on a nonrecourse basis to outside financial institutions were as follows as of the dates indicated:

### Loan Participations Sold

December 31, (in thousands)	
2007	\$ 201,776
2006	188,994
2005	183,795
2004	131,317
2003	146,988

### Concentrations of Credit

See Note 6 in the audited financial statements for concentration of credit information.

### Loan Maturities

The following table sets forth the remaining maturities of loans in each major category of our portfolio as of December 31, 2007 (in thousands):

### Maturities of Loans (1)

	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	\$ 76,916	\$ 16,629	\$ 11,423	\$ 14,303	\$ 6,284	\$ 125,555
Real estate mortgage	26,203	34,015	66,697	27,602	26,483	181,000
Real estate construction	83,499	1,519	73,446	197	8,684	167,345
Agricultural	8,340	4,537	233	2,653	1,311	17,074
Consumer/other	2,671	2,315	506	136	250	5,878
Participating interests in mortgage loans	24,357	1,815	-	-	-	26,172
Lease financing	-	-	-	-	-	-
Total principal amount of loans	<u>\$ 221,986</u>	<u>\$ 60,830</u>	<u>\$ 152,305</u>	<u>\$ 44,891</u>	<u>\$ 43,012</u>	<u>\$ 523,024</u>

(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.

### **Provision for Credit Losses**

We determine a provision for credit losses which we consider sufficient to maintain our allowance for credit losses at a level considered adequate to provide for an estimate of probable losses in the loan and lease portfolio that have been incurred as of each balance sheet date. The provision for credit losses for the year ended December 31, 2007 was \$3.750 million as compared to \$210 thousand in 2006. The provision for loan losses increased in 2007 due to loan growth and an increase of classified assets.

### **Allowance for Credit Losses**

Credit risk is the risk of loss from a customer default. We have in place a process to identify and manage our credit risk. The process includes initial credit review and approval, periodic monitoring to measure compliance with credit agreements and internal credit policies, internal credit review, monitoring changes in the risk ratings of loans and leases, identification of problem loans and leases and special procedures for collection of problem loans and leases. The risk of loss is difficult to quantify and is subject to fluctuations in values and general economic conditions and other factors. The determination of the allowance for credit losses is a critical accounting policy, which involves estimates and our judgment on a number of factors such as net charge-offs, delinquencies in the loan and lease portfolio and general and economic conditions.

The following table summarizes, for the periods indicated, activity in the allowance for credit losses, including amounts of loans charged-off, amounts of recoveries, additions to the allowance charged to operating expense, the ratio of net charge-offs to average total loans, the ratio of the allowance to total loans at the end of each period and the ratio of the allowance to nonperforming loans:

## Analysis of Allowance for Credit Losses

(dollars are in thousands)

	For the Years ended December 31,				
	2007	2006	2005	2004	2003
Balance of allowance for credit losses, beginning of period	\$ 3,370	\$ 3,188	\$ 3,335	\$ 4,763	\$ 5,006
<b>Charge-offs:</b>					
Commercial and industrial	1,504	19	534	1,578	1,508
Real estate mortgage	500	-	24	-	189
Real estate construction	-	-	-	-	-
Agricultural	-	-	-	97	10
Consumer/other	123	32	31	208	23
Lease financing	-	-	-	--	90
Total charge-offs	2,127	51	589	1,883	1,820
<b>Recoveries:</b>					
Commercial and industrial	1,500	3	95	141	73
Real estate mortgage	-	-	10	33	7
Real estate construction	-	-	16	-	-
Agricultural	-	-	-	-	-
Consumer/other	106	20	69	97	11
Lease financing	-	-	2	9	11
Total recoveries	1,606	23	192	280	102
Net charge-offs	(521)	(28)	(397)	(1,603)	(1,718)
Provision for credit losses charged to operations	3,750	210	250	175	1,475
Balance of allowance for credit losses, end of period	\$ 6,599	\$ 3,370	\$ 3,188	\$ 3,335	\$ 4,763
Ratio of net charge-offs to average total loans	(0.121)%	(0.008)%	(0.102)%	(0.548)%	(0.558)%
Ratio of net charge-offs to average loans and leases held for investment	(0.129)%	(0.008)%	(0.130)%	(0.579)%	(0.560)%
Average gross loans and leases held for investment	\$ 402,615	\$ 334,058	\$ 305,073	\$ 276,652	\$ 306,949
Ratio of allowance for credit losses to loans and leases held for investment	1.33%	1.01%	1.03%	1.14%	1.68%
Ratio of allowance for credit losses to total nonperforming loans	122%	3,304%	2,229%	607%	60%

Charge-offs of real estate mortgage loans increased in 2007 by \$500 thousand. We recorded a charge-off of \$500 thousand to reflect the imputed interest rate on a restructured loan.

The allowance for credit losses increased significantly during 2007 because of growth in the portfolio and an increase in the balance of loans we consider to be impaired.

We consider the allowance for credit losses adequate to cover losses inherent in the loan and lease portfolio as of December 31, 2007. However, no assurance can be given that we will not, in any particular period, sustain loan and lease losses that are sizable in relation to the amount reserved, or that subsequent evaluations of the loan and lease portfolio, in light of factors then prevailing, including economic conditions and our ongoing credit review process, will not require significant increases in the allowance for credit losses. A protracted economic slowdown and/or a decline in commercial, industrial or real estate segments may have an adverse impact on the adequacy of the allowance for credit losses by increasing credit risk and the risk of potential loss. See Notes 1 and 7 to the Consolidated Financial Statements and “-Critical Accounting Policies” for further information concerning accounting policies associated with the allowance for credit losses.

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

(dollars are in thousands)

	December 31,									
	2007		2006		2005		2004		2003	
	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	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	Amount of allowance	Loans in category as a percentage of total gross loans
Commercial and industrial	\$ 1,410	24%	\$ 1,602	26%	\$ 1,632	21%	\$ 1,583	23%	\$ 2,093	26%
Real estate mortgage (a)	1,956	35%	838	32%	846	30%	1,116	39%	1,976	46%
Real estate construction (a)	2,740	32%	534	23%	467	19%	379	21%	395	21%
Agricultural	276	3%	171	4%	158	3%	186	4%	211	4%
Consumer/other	112	1%	70	1%	73	1%	62	2%	68	2%
Participating interests in mortgage loans	85	5%	140	14%	-	25%	-	11%	-	0%
Lease financing	20	-	15	-	12	1%	9	0%	20	1%
Total	\$ 6,599	100%	\$ 3,370	100%	\$ 3,188	100%	\$ 3,335	100%	\$ 4,763	100%

(a) In 2007, the portion of our allowance that was allocated to real estate loans increased due to higher risk in an environment where real estate is devaluing.

### Allowance for Credit Losses; Impact on Earnings.

The level of the allowance for credit losses involves assumptions underlying our estimates that reflect highly uncertain matters in the current period. Additionally, a different estimate that could have been used in the current period could have had a material impact on reported financial condition or results of operations. We are not aware, at this time, of known trends, commitments, events or other uncertainties reasonably likely to occur that would materially affect our methodology or the assumptions used, although changes in qualitative and quantitative factors could occur at any time and such changes could be of a material nature. We have used our assumptions to arrive at the level of the allowance for credit losses that we consider adequate to provide for an estimate of probable losses in the loan and lease portfolio that have been incurred as of December 31, 2007.

From period to period, economic situations change, credits may deteriorate or improve and the other factors we consider in arriving at our estimates may change. However, our basic methodology for determining an appropriate allowance for credit losses has remained relatively stable. The amount of the provision for credit losses charged to operations is directly related to our estimates of the appropriate level of the allowance for credit losses. Charge-offs and recoveries during the applicable periods also impact the level of the allowance for credit losses resulting in a provision for credit losses that could be higher or lower in order to bring the allowance for credit losses in line with our estimates.

### Nonperforming Loans and Assets

Nonperforming loans consist of loans 90 days or more delinquent and still accruing interest, non-accrual and restructured loans. Other nonperforming assets include other real estate owned and repossessed assets. Our lending personnel are responsible for continuous monitoring of the quality of the loan portfolio. Loan officers are expected to maintain loan quality and deal with credit issues in a timely and proactive manner. Loan officers are also responsible for regular reviews of past due loans in their respective portfolios. The loan portfolio is also monitored regularly and examined by our loan review personnel. Loans demonstrating weaknesses are downgraded in a timely fashion and the Board receives a listing of all criticized and classified loans on a quarterly basis.

The following table sets forth, as of the dates indicated, the amounts of nonperforming loans and other assets, the allowance for credit losses and certain related ratios (dollars are in thousands):

### Nonperforming Assets

	December 31,				
	2007	2006	2005	2004	2003
<b>Nonperforming loans:</b>					
Loans 90 days or more delinquent and still accruing interest	\$ -	\$ 2	\$ -	\$ 25	\$ 38
Non-accrual loans	5,399	100	143	524	7,913
Total nonperforming loans	<u>\$ 5,399</u>	<u>\$ 102</u>	<u>\$ 143</u>	<u>\$ 549</u>	<u>\$ 7,951</u>
Total nonperforming assets	<u>\$ 5,399</u>	<u>\$ 102</u>	<u>\$ 143</u>	<u>\$ 549</u>	<u>\$ 7,951</u>
Allowance for credit losses	<u>\$ 6,599</u>	<u>\$ 3,370</u>	<u>\$ 3,188</u>	<u>\$ 3,335</u>	<u>\$ 4,763</u>
Ratio of total nonperforming loans to total loans	1.03%	0.03%	0.03%	0.16%	2.80%
Ratio of total nonperforming loans to loans and leases held for investment	1.09%	0.03%	0.05%	0.19%	2.81%
Ratio of total nonperforming assets to total assets	0.77%	0.02%	0.02%	0.09%	1.34%
Ratio of allowance for credit losses to nonperforming loans	122%	3,304%	2,229%	607%	60%

### Past Due, Non-accrual and Restructured Loans

As of December 31, 2007 and 2006, the Bank had \$0 of loans past due 90 days or more and still accruing interest. As of December 31, 2007 and 2006, the Bank had \$5.4 million and \$100,000, respectively, of non-accrual loans. As of December 31, 2007 and 2006, the Bank also had \$2.6 million and \$54,000, respectively, of restructured loans. The table below summarizes the amounts of restructured loans. All of the restructured loans were also non-accrual loans.

<b>Restructured Loans</b>	
<b>As of December 31,</b>	
2007	\$ 2,585
2006	54
2005	91
2004	-
2003	-

The following table indicates the effect on income if interest on non-accrual and restructured loans outstanding at year end had been recognized at original contractual rates during the year ended December 31 (in thousands):

	<b>2007</b>
Interest income that would have been recorded	\$ 262
Interest income recorded	146
Effect on interest income	<u>\$ 116</u>

Cash receipts on restructured loans are generally recognized in accordance with the restructured terms. If collection of principal and interest on restructured loans is in doubt, interest income is recognized on a cash basis. A loan that has performed in accordance with its restructured terms for one year is no longer reported as a restructured loan.

**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. Our lending and management personnel monitor these loans closely.

**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 a problem loan is finally resolved, there may ultimately be an actual write down or charge-off of the principal balance of the loan which may necessitate additional charges to earnings.

**Restructured loans** are those for which concessions, including a reduction of the interest rate or the deferral of interest or principal, have been granted due to the borrower's weakened financial condition. Interest on restructured loans is accrued at the restructured rates when it is anticipated that no loss of original principal will occur.

**Other real estate owned and repossessed assets** represent properties and other assets acquired through, or in lieu of, loan foreclosure. They are initially recorded at fair value at the date of acquisition establishing a new cost basis. Write-downs to fair value at the time of acquisition are charged to the allowance for credit losses. After foreclosure, we perform valuations periodically and the real estate or assets are carried at the lower of carrying amount or fair value less cost to sell. Write-downs, revenues and expenses incurred subsequent to foreclosure are charged to operations as recognized/incurred. We had no outstanding other real estate owned or repossessed assets at December 31, 2007 or 2006.

Our balances of nonperforming loans and assets have been insignificant in recent years. Accordingly, the ratio of the allowance for losses to nonperforming loans has been relatively high.

#### **Impaired loans**

See Note 6 in the audited financial statements for impaired loans information.

#### **Potential Problem Loans**

Potential problems loans are loans that are currently performing but have higher than usual inherent risk. Certain components of the residential housing, residential development, and mortgage banking are operating in markets that are currently facing challenges. We also have a significant investment in land and construction loans. To the extent we have loans in these markets and industries our exposure to credit risk is higher than usual. As disclosed in Note 6 of the audited financial statements we have impaired loans and credit concentrations. We also have \$4.5 million of loans which deserve higher than usual monitoring.

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.

#### **Liabilities and Stockholders' Equity**

The following table presents our liabilities and stockholders' equity of December 31, 2007 and 2006 (dollars are in thousands):

## Liabilities and Stockholders' Equity

	As of December 31,		Increase (Decrease)	
	2007	2006	2007 – 2006	
			\$	%
Deposits:				
Non-interest-bearing	\$ 72,234	\$ 84,184	\$ (11,950)	(14) % (a)
Interest-bearing-				
Savings, interest checking and money market	245,722	253,408	(7,686)	(3) %
Time deposits \$100,000 and over	44,038	44,955	(917)	(2) %
Other time deposits	179,880	146,705	33,175	23 % (b)
Short-term borrowings	5,365	9,709	(4,344)	(45) % (c)
FHLB advances	61,400	62,200	(800)	(1) % (d)
Long-term borrowings	-	1,167	(1,167)	(100) % (e)
Guaranteed preferred beneficial interests in Company's subordinated debentures	23,075	22,711	364	2 % (f)
Accrued expenses	3,387	1,640	1,747	107 %
Other liabilities	4,172	3,319	853	26 %
Liabilities from discontinued operations	588	6,676	(6,088)	(91) % (g)
Total liabilities	639,861	636,674	3,187	1 %
Stockholders' equity	59,730	55,602	4,128	7 % (h)
Total	\$ 699,591	\$ 692,276	\$ 7,315	1 %

(a) These accounts fluctuate daily due to the cash management activities of our customers.

(b) The increase is due to deposits we have purchased in the CDARs Network.

(c) Short-term borrowings can fluctuate significantly depending on our need to finance assets and opportunities to borrow from customers.

(d) During 2007, we prepaid all of the advances outstanding at the end of 2006. At the end of 2007, we have elected to finance growth in loans and leases held for investment with short term advances in order to manage our interest rate risk profile.

(e) Long-term liabilities were repaid in 2007 because the rates on these borrowing were high compared to alternative borrowings.

(f) During 2007, we refinanced \$15 million of subordinated debentures in order to lower the rate paid on the debentures.

(g) Liabilities of discontinued operations decreased in 2007 because we sold substantially all of BNC Insurance.

(h) Stockholders' equity has increased due to earnings and the increase of unrealized gains in the investment portfolio.

## Deposits

The following table sets forth, for the periods indicated, the distribution of our average deposit account balances and average cost of funds rates on each category of deposits (dollars are in thousands):

## Average Deposits and Deposits Costs

	For the Years Ended December 31,								
	2007			2006			2005		
	Average balance	Percent of deposits	Wgtd. avg. rate	Average balance	Percent of deposits	Wgtd. avg. rate	Average balance	Percent of deposits	Wgtd. avg. rate
Interest checking and MMDAs	\$ 249,246	47.95%	3.21%	\$ 246,476	46.68%	3.02%	\$ 236,832	46.93%	2.13%
Savings deposits	8,399	1.62%	0.79%	8,398	1.59%	0.79%	7,935	1.57%	0.79%
<b>Time deposits (CDs):</b>									
CDs under \$100,000	149,010	28.67%	4.79%	150,194	28.45%	4.29%	114,157	22.62%	3.11%
CDs \$100,000 and over	44,824	8.62%	5.17%	54,155	10.26%	4.61%	79,977	15.85%	4.00%
Total time deposits	<u>193,834</u>	<u>37.29%</u>	4.88%	<u>204,349</u>	<u>38.70%</u>	4.37%	<u>194,134</u>	<u>38.47%</u>	3.47%
Total interest-bearing deposits	451,479	86.86%	3.88%	459,223	86.98%	3.58%	438,901	86.98%	2.70%
Non-interest-bearing demand deposits	68,277	13.14%	-	68,743	13.02%	-	65,707	13.02%	-
Total deposits	<u>\$ 519,756</u>	<u>100.00%</u>	3.37%	<u>\$ 527,966</u>	<u>100.00%</u>	3.11%	<u>\$ 504,608</u>	<u>100.00%</u>	2.35%

At times earning asset growth can outpace core deposit growth resulting in the use of brokered deposits and out of market certificates of deposit and other borrowed funds. This trend has been common in the banking industry because of the proliferation of nonbank competitors and the multitude of financial and investment products available to customers as well as the need to utilize such funds in the process of our overall balance sheet management. At times, access to brokered and out of market deposits is available at maturities and rates more favorable than those available in our local markets.

Time deposits, in denominations of \$100,000 and more, totaled \$44.0 million at December 31, 2007 as compared to \$45.0 million at December 31, 2006. The following table sets forth the amount and maturities of time deposits of \$100,000 and more as of December 31, 2007 (in thousands):

### Time Deposits of \$100,000 and Over

#### Maturing in:

3 months or less	\$	8,115
Over 3 months through 6 months		9,160
Over 6 months through 12 months		25,131
Over 12 months		1,632
Total	<u>\$</u>	<u>44,038</u>

### Borrowed Funds

The following table provides a summary of our short-term borrowings and related cost information as of, or for the periods ended, December 31 (dollars are in thousands):

### Short-Term Borrowings

	2007	2006	2005
Short-term borrowings outstanding at period end	\$ 5,365	\$ 9,709	\$ 21,416
Weighted average interest rate at period end	3.59%	4.81%	3.98%
Maximum month-end balance during the period	\$ 15,518	\$ 21,059	\$ 48,516
Average borrowings outstanding for the period	\$ 8,706	\$ 14,480	\$ 24,001
Weighted average interest rate for the period	4.57%	4.73%	3.15%

Note 12 to the Consolidated Financial Statements summarizes the general terms of our short-term borrowings outstanding at December 31, 2007 and 2006, including interest rates, maturity dates, weighted average yields and other applicable terms.

FHLB advances totaled \$61.4 and \$62.2 million at December 31, 2007 and 2006, respectively, while long-term borrowings totaled \$0 and \$1.2 million, respectively, for the same periods.

Notes 13 and 14 to the Consolidated Financial Statements summarize the general terms of our FHLB advances and long-term borrowings at December 31, 2007 and 2006, including interest rates, maturity dates, weighted average yields and other applicable terms.

### **Guaranteed Preferred Beneficial Interests in Company's Subordinated Debentures**

See Note 15 to the Consolidated Financial Statements for a complete description of the subordinated debentures.

### **Capital Resources and Expenditures**

We actively monitor compliance with regulatory capital requirements, including risk-based and leverage capital measures. Under the risk-based capital method of capital measurement, the ratio computed is dependent on the amount and composition of assets recorded on the balance sheet, and the amount and composition of off-balance-sheet items, in addition to the level of capital. Note 19 to the Consolidated Financial Statements includes a summary of the risk-based and leverage capital ratios of BNCCORP and the Bank as of December 31, 2007 and 2006.

The capital ratios of the Company and the Bank were as follows as of those dates:

	<u>Tier 1 Risk- Based Ratio</u>	<u>Total Risk- Based Ratio</u>	<u>Tier 1 Leverage Ratio</u>
As of December 31, 2007			
BNCCORP, consolidated	12.58%	14.26%	12.01%
BNC National Bank	13.18%	14.26%	12.57%
As of December 31, 2006			
BNCCORP, consolidated	9.49%	10.89%	7.12%
BNC National Bank	10.26%	10.94%	7.70%

The changes in capital ratios between December 31, 2007 and December 31, 2006 are primarily due to 2007 earnings and a reduction of intangible assets when we sold substantially all of the assets of BNC Insurance in 2007.

### **Off-Balance-Sheet Arrangements**

In the normal course of business, we are a party to various financial instruments with off-balance-sheet risk. These instruments include commitments to extend credit, commercial letters of credit, performance and financial standby letters of credit and interest rate swaps, caps and floors. Such instruments help us to meet the needs of our customers, manage our interest rate risk and effectuate business combination transactions. These instruments and commitments, which we enter into for purposes other than trading, carry varying degrees of credit, interest rate or liquidity risk in excess of the amount reflected in the consolidated balance sheets. We have also entered into certain guarantee arrangements that are not reflected in the consolidated balance sheets. See Notes 21 and 22 to the Consolidated Financial Statements for a detailed description of each of these instruments.

### **Contractual Obligations, Contingent Liabilities and Commitments**

As disclosed in the Notes to the Consolidated Financial Statements, we have certain contractual obligations, contingent liabilities and commitments. At December 31, 2007, the aggregate contractual obligations (excluding bank deposits), contingent liabilities and commitments were as follows (in thousands):

	<b>Payments due by period</b>				
	<b>Less than 1 year</b>	<b>1 to 3 years</b>	<b>3 to 5 years</b>	<b>After 5 years</b>	<b>Total</b>
<b>Contractual Obligations:</b>					
Total borrowings	\$ 66,765	\$ -	\$ -	\$ 23,075	\$ 89,840
Annual rental commitments under non-cancelable operating leases	577	1,336	905	1,680	4,498
<b>Total</b>	<b>\$ 67,342</b>	<b>\$ 1,336</b>	<b>\$ 905</b>	<b>\$ 24,755</b>	<b>\$ 94,338</b>

	<b>Amount of Commitment - Expiration by Period</b>				
	<b>Less than 1 year</b>	<b>1 to 3 years</b>	<b>3 to 5 years</b>	<b>After 5 years</b>	<b>Total</b>
<b>Other Commitments:</b>					
Commitments to lend	\$ 146,768	\$ 50,350	\$ 3,448	\$ 2,584	\$ 203,150
Standby and commercial letters of credit	8,181	911	40	-	9,132
<b>Total</b>	<b>\$ 154,949</b>	<b>\$ 51,261</b>	<b>\$ 3,488</b>	<b>\$ 2,584</b>	<b>\$ 212,282</b>

We are a party to transactions involving financial instruments that create risks that may or may not be reflected on a traditional balance sheet. These financial instruments can be subdivided into two categories:

Cash financial instruments, generally characterized as on-balance-sheet items; include investments, loans, mortgage-backed securities, deposits and debt obligations.

Credit-related financial instruments, generally characterized as off-balance-sheet items, include such instruments as commitments to extend credit, commercial letters of credit and performance and financial standby letters of credit.

## 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 generally 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.

The following table sets forth a summary of our major sources and (uses) of funds (in thousands):

	<b>For the Years Ended December 31,</b>	
	<b>2007</b>	<b>2006</b>
Proceeds of Federal Home Loan Bank advances	\$ 319,400	\$ -
Repayments of Federal Home Loan Bank advances	(320,200)	(20,000)
Originations paid of loans to be participated	(205,929)	(141,603)
Proceeds received from participations of loans	205,929	141,603
Net increase in loans held for investment	(163,622)	(23,566)
Net decrease in participating interests in mortgage loans	31,768	45,211
Net increase (decrease) in deposits	12,622	(19,538)
Change in Federal Funds sold, net	24,000	(24,000)
Proceeds from sales of investment securities	106,450	43,691
Purchases of investment securities	(71,196)	(26,053)
Proceeds from maturities of investment securities	26,379	25,053
Proceeds from sale of loans held for sale	13,033	24,250
Funding of originations of loans held for sale	(11,364)	(25,923)
Proceeds from sale of insurance operations, net	35,204	-
Proceeds from long-term borrowings and subordinated debentures	15,000	-
Repayments from long-term borrowings and subordinated debentures	(16,167)	(2,682)

Our liquidity is measured by our ability to raise cash when we need it at a reasonable cost and with a minimum of loss. 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 a monthly 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.

As of December 31, 2007, the Bank had established three additional federal funds purchased lines with correspondent banks, totaling \$17.5 million. At December 31, 2007, the Bank had not drawn on these lines. The lines, if drawn upon, mature daily with interest rates that float at the federal funds rate. The Bank has also been approved for repurchase agreement lines of up to \$100.0 million with a major financial institution. The lines, if utilized, would be collateralized by investment securities.

## **Forward-Looking Statements**

Statements included in Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" which are not historical in nature are intended to be, and are hereby identified as "forward-looking statements" for purposes of the safe harbor provided by Section 27A of the Securities Act and Section 21E of the Exchange Act. We caution readers that these forward-looking statements, including without limitation, those relating to our future business prospects, revenues, working capital, liquidity, capital needs, interest costs, income and

expenses, are subject to certain risks and uncertainties that could cause actual results to differ materially from those indicated in the forward-looking statements due to several important factors. These factors include, but are not limited to: risks of loans and investments, including dependence on local and regional economic conditions; competition for our customers from other providers of financial services; possible adverse effects of changes in interest rates including the effects of such changes on derivative contracts and associated accounting consequences; risks associated with our acquisition and growth strategies; and other risks which are difficult to predict and many of which are beyond our control.

### **Effects of Inflation**

Unlike most industrial companies, the assets and liabilities of financial institutions are primarily monetary in nature. Therefore, banking organizations do not necessarily gain or lose due to the effects of inflation. Changes in interest rates, which are a major determinant of a financial service organization's profitability, do not necessarily correspond to changes in the prices of goods and services; however, interest rates may change in response to changes in expectations of future inflation. An analysis of a banking organization's asset and liability structure provides the best indication of how the organization is positioned to respond to changing interest rates and maintain profitability.

The financial statements and supplementary financial data have been prepared, primarily, on a historical basis, which is mandated by accounting principles generally accepted in the United States. Fluctuations in the relative value of money due to inflation or recession are generally not considered.

### **Recently Issued and Adopted Accounting Pronouncements**

Note 1 to the Consolidated Financial Statements includes a summary of recently issued and adopted accounting pronouncements and their related or anticipated impact on the Company.

### **Critical Accounting Policies**

Note 1 to the Consolidated Financial Statements includes a summary of our critical accounting policies and their related impact on the Company.

## **Item 7A. 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 sweeps, 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. See “-Loan Portfolio-Interest Rate Caps

and Floors” “-Borrowings-Interest Rate Caps and Floors” and Notes 1 and 18 to the Consolidated Financial Statements for a summary of our accounting policies pertaining to such instruments.

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 December 31, 2007 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 December 31, 2007 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 quarterly basis at regularly scheduled ALCO meetings. Each quarter net interest income is generally simulated for the upcoming 12-month horizon in seven interest scenarios. The scenarios generally modeled are parallel interest ramps of +/- 100bp, 200bp, and 300bp along with a rates unchanged scenario. 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 will decrease from its starting point at December 31, 2007 of 7.25% to 6.25% 12 months later. The prime rate in this example will decrease 1/12<sup>th</sup> of the overall decrease of 100 basis points each month. The parallel movement of interest rates takes the level of the 10-year U.S. Treasury note yield in the -200bp scenario to 2.03%. This is nearly 108bp below the June 13, 2003 low for the 10-year U.S. Treasury note yield of 3.11%. Therefore, the level of mortgage prepayment activity built into the model is increased accordingly.

The net interest income simulation result for the 12-month horizon that covers the calendar year of 2008 is shown below:

#### Net Interest Income Simulation

Movement in interest rates	<u>-300bp</u>	<u>-200bp</u>	<u>-100bp</u>	<u>Unchanged</u>	<u>+100bp</u>	<u>+200bp</u>	<u>+300bp</u>
Projected 12-month net interest income	\$ 27,716	\$ 27,599	\$ 27,001	\$ 26,154	\$ 26,042	\$ 26,044	\$ 26,059
Dollar change from unchanged scenario	\$ 1,562	\$ 1,445	\$ 847	-	\$ (112)	\$ (110)	\$ (95)
Percentage change from unchanged scenario	5.97%	5.52%	3.24%	-	(0.43)	(0.42)	(0.36)
Policy guidelines (decline limited to)	(15.00)%	(10.00)%	(5.00)%	-	(5.00)%	(10.00)%	(15.00)%

Our rate sensitivity position over the projected 12-month horizon is liability sensitive. This is evidenced by the projected increase in net interest income in the declining interest rate scenarios.

Our general policy is to limit the percentage decrease in projected net interest income to 5, 10, and 15% from the rates unchanged scenario for the +/- 100bp, 200bp, and 300bp interest rate ramp scenarios, respectively.

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 December 31, 2007. 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 December 31, 2007				Total
	0-3 months	4-12 months	1-5 years	Over 5 years	
	(dollars are in thousands)				
<b>Interest-earning assets:</b>					
Interest-bearing deposits with banks	\$ -	\$ -	\$ -	\$ -	\$ -
Investment securities	8,220	20,222	60,897	33,560	122,899
FRB and FHLB stock	4,918	-	-	-	4,918
Fed Funds Sold	-	-	-	-	-
Loans held for sale, fixed rate	-	-	-	-	-
Loans held for sale, floating rate	-	24,357	-	-	24,357
Loans held for investment, fixed rate	12,675	48,673	62,953	21,454	145,755
Loans held for investment, floating rate	326,098	3,367	20,675	1,661	351,801
Total interest-earning assets	<u>\$ 351,911</u>	<u>\$ 96,619</u>	<u>\$ 144,525</u>	<u>\$ 56,675</u>	<u>\$ 649,730</u>
<b>Interest-bearing liabilities:</b>					
Interest checking and money market accounts	\$ 237,334	\$ -	\$ -	\$ -	\$ 237,334
Savings	8,388	-	-	-	8,388
Time deposits under \$100,000	8,115	34,291	1,632	-	44,038
Time deposits \$100,000 and over	80,936	92,159	6,311	474	179,880
Short-term borrowings	5,365	-	-	-	5,365
FHLB advances	61,400	-	-	-	61,400
Long-term borrowings	-	-	-	-	-
Subordinated debentures	-	-	-	23,075	23,075
Total interest-bearing liabilities	<u>\$ 401,538</u>	<u>\$ 126,450</u>	<u>\$ 7,943</u>	<u>\$ 23,549</u>	<u>\$ 559,480</u>
Interest rate gap	<u>\$ (49,627)</u>	<u>\$ (29,831)</u>	<u>136,582</u>	<u>\$ 33,126</u>	<u>\$ 90,250</u>
Cumulative interest rate gap at December 31, 2007	<u>\$ (49,627)</u>	<u>\$ (79,458)</u>	<u>\$ 57,124</u>	<u>90,250</u>	
Cumulative interest rate gap to total assets	(7.09)%	(11.36)%	8.17%	12.90%	

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 aggressive 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 December 31, 2007 and do not contemplate any actions we might undertake in response to changes in market interest rates.