



BNCCORP, INC. AND SUBSIDIARIES
Consolidated Financial Statements
December 31, 2008 and 2007
(With Independent Auditors' Report Thereon)

BNCCORP, INC. AND SUBSIDIARIES

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Independent Auditors' Report

The Board of Directors and Stockholders
BNCCORP, Inc.:

We have audited the accompanying consolidated balance sheets of BNCCORP, Inc. and subsidiaries (the Company) as of December 31, 2008 and 2007, and the related consolidated statements of income, comprehensive income, stockholders' equity, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of BNCCORP, Inc. and subsidiaries as of December 31, 2008 and 2007, and the results of their operations and their cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

KPMG LLP

Omaha, Nebraska
March 23, 2009

BNCCORP, INC. AND SUBSIDIARIES

Consolidated Balance Sheets

December 31, 2008 and 2007

(In thousands, except share data)

Assets	2008	2007
Cash and cash equivalents	\$ 10,569	14,856
Investment securities available for sale	209,857	122,899
Federal Reserve Bank and Federal Home Loan Bank stock	5,989	4,918
Loans held for sale	13,403	—
Participating interests in mortgage loans	28,584	24,357
Loans and leases held for investment	542,753	497,556
Allowance for credit losses	(8,751)	(6,599)
Net loans and leases	562,586	515,314
Other real estate owned	10,189	—
Premises and equipment, net	20,810	19,448
Interest receivable	3,263	3,290
Other assets	24,832	15,294
Premises and equipment held for sale, net	—	3,572
Total assets	\$ 861,498	699,591
Liabilities and Stockholders' Equity		
Deposits:		
Noninterest-bearing	\$ 68,996	72,234
Interest-bearing:		
Savings, interest checking and money market	266,851	245,722
Time deposits \$100,000 and over	42,342	44,038
Other time deposits	297,132	179,880
Total deposits	675,321	541,874
Short-term borrowings	16,844	5,365
Federal Home Loan Bank advances	84,500	61,400
Long-term borrowings	—	—
Guaranteed preferred beneficial interests in Company's subordinated debentures	23,025	23,075
Accrued interest payable	1,679	2,843
Accrued expenses	3,325	3,387
Other liabilities	2,857	1,917
Total liabilities	807,551	639,861
Stockholders' equity:		
Preferred stock, \$0.01 par value. Authorized 2,000,000 shares; no shares issued or outstanding	—	—
Common stock, \$0.01 par value. Authorized 10,000,000 shares; 3,299,163 and 3,491,337 shares issued and outstanding	33	35
Capital surplus – common stock	26,628	26,355
Retained earnings	36,104	34,105
Treasury stock, at cost (357,738 and 150,116 shares)	(5,020)	(2,424)
Accumulated other comprehensive income (loss), net	(3,798)	1,659
Total stockholders' equity	53,947	59,730
Total liabilities and stockholders' equity	\$ 861,498	699,591

See accompanying notes to consolidated financial statements.

BNCCORP, INC. AND SUBSIDIARIES

Consolidated Statements of Income

Years ended December 31, 2008 and 2007

(In thousands, except share data)

	<u>2008</u>	<u>2007</u>
Interest income:		
Interest and fees on loans	\$ 35,322	36,560
Interest and dividends on investments:		
Taxable	9,599	6,541
Tax-exempt	839	926
Dividends	266	214
Total interest income	<u>46,026</u>	<u>44,241</u>
Interest expense:		
Deposits	15,099	17,533
Short-term borrowings	144	398
Federal Home Loan Bank advances	2,291	1,915
Long-term borrowings	25	11
Subordinated debentures	1,656	2,137
Total interest expense	<u>19,215</u>	<u>21,994</u>
Net interest income	26,811	22,247
Provision for credit losses	7,750	3,750
Net interest income after provision for credit losses	<u>19,061</u>	<u>18,497</u>
Non-interest income:		
Bank charges and service fees	2,337	2,010
Wealth management revenues	2,826	2,041
Mortgage banking revenues	2,101	158
Gains on sales of commercial real estate loans	1,116	1,731
Gain on sales of premises and equipment	775	—
Net gain (loss) on sales of securities	247	(3,277)
Other	993	1,190
Total non-interest income	<u>10,395</u>	<u>3,853</u>
Non-interest expense:		
Salaries and employee benefits	14,673	14,868
Data processing fees	2,202	2,524
Occupancy	2,140	2,074
Depreciation and amortization	1,375	1,697
Marketing and promotion	1,127	703
Professional services	1,177	840
FDIC and other assessments	400	228
Office supplies, telephone and postage	533	499
ORE expenses	515	—
Debt extinguishment costs	—	2,724
Other	2,359	1,990
Total non-interest expense	<u>26,501</u>	<u>28,147</u>
Income (loss) from continuing operations before income taxes	2,955	(5,797)
Income tax expense (benefit)	737	(2,728)
Income (loss) from continuing operations	<u>2,218</u>	<u>(3,069)</u>

BNCCORP, INC. AND SUBSIDIARIES

Consolidated Statements of Income

Years ended December 31, 2008 and 2007

(In thousands, except share data)

	<u>2008</u>	<u>2007</u>
Discontinued operations:		
Income from discontinued insurance segment	\$ —	8,116
Income tax expense	—	3,067
	<u>—</u>	<u>5,049</u>
Income from discontinued operations	—	5,049
Net income	\$ <u>2,218</u>	<u>1,980</u>
Basic earnings per common share:		
Income (loss) from continuing operations	\$ 0.67	(0.89)
Income from discontinued insurance segment, net of income taxes	—	1.46
	<u>0.67</u>	<u>0.57</u>
Basic earnings per common share	\$ <u>0.67</u>	<u>0.57</u>
Diluted earnings per common share:		
Income (loss) from continuing operations	\$ 0.67	(0.89)
Income from discontinued insurance segment, net of income taxes	—	1.46
	<u>0.67</u>	<u>0.57</u>
Diluted earnings per common share	\$ <u>0.67</u>	<u>0.57</u>

See accompanying notes to consolidated financial statements.

BNCCORP, INC. AND SUBSIDIARIES
Consolidated Statements of Comprehensive Income
Years ended December 31, 2008 and 2007
(In thousands)

	2008	2007
Net income	\$ 2,218	1,980
Unrealized gain on cash flow hedge, net	1,332	690
Unrealized gain (loss) on securities available for sale	(9,836)	1,720
Reclassification adjustment for (gains) losses included in net income	(247)	3,277
Other comprehensive income (loss), before tax	(8,751)	5,687
Income tax (expense) benefit related to items of other comprehensive income	3,294	(2,117)
Other comprehensive income (loss)	(5,457)	3,570
Total comprehensive income (loss)	\$ (3,239)	5,550

See accompanying notes to consolidated financial statements.

BNCCORP, INC. AND SUBSIDIARIES
Consolidated Statements of Stockholders' Equity
Years ended December 31, 2008 and 2007
(In thousands, except share data)

	Preferred stock		Common stock		Capital surplus common stock	Retained earnings	Treasury stock	Accumulated other comprehensive income (loss)	Total
	Shares	Amount	Shares	Amount					
Balance, December 31, 2006	—	\$ —	3,600,467	\$ 36	25,950	32,125	(598)	(1,911)	55,602
Net income	—	—	—	—	—	1,980	—	—	1,980
Other comprehensive income	—	—	—	—	—	—	—	3,570	3,570
Impact of share-based compensation	—	—	(14,348)	—	405	—	(107)	—	298
Purchase of common shares	—	—	(94,782)	(1)	—	—	(1,719)	—	(1,720)
Balance, December 31, 2007	—	—	3,491,337	35	26,355	34,105	(2,424)	1,659	59,730
Net income	—	—	—	—	—	2,218	—	—	2,218
Other comprehensive loss	—	—	—	—	—	—	—	(5,457)	(5,457)
Cumulative effect of change in accounting principle related to split-dollar life insurance policies	—	—	—	—	—	(219)	—	—	(219)
Impact of share-based compensation	—	—	8,152	—	273	—	—	—	273
Purchase of common shares	—	—	(200,326)	(2)	—	—	(2,596)	—	(2,598)
Balance, December 31, 2008	—	\$ —	3,299,163	\$ 33	26,628	36,104	(5,020)	(3,798)	53,947

See accompanying notes to consolidated financial statements.

BNCCORP, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

Years ended December 31, 2008 and 2007

(In thousands)

	<u>2008</u>	<u>2007</u>
Operating activities:		
Net income	\$ 2,218	1,980
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Provision for credit losses	7,750	3,750
Depreciation and amortization	1,375	1,752
Net amortization of premiums (discounts) on investment securities and subordinated debentures	(1,164)	163
Fair value adjustment for loans held for sale	(268)	—
Share-based compensation	273	298
Change in other assets, net	(3,877)	(419)
Loss on sale of ORE	38	—
(Gain) loss on sales of bank premises and equipment, net	(775)	11
Net realized (gain) loss on sales of investment securities	(247)	3,277
Deferred income taxes	(1,158)	(1,325)
Unamortized premium related to early extinguishment of subordinated debt	—	289
Change in other liabilities, net	(138)	1,733
Originations of loans to be participated	(201,489)	(205,929)
Proceeds from participations of loans	201,489	205,929
Funding of originations of loans held for sale	(102,040)	(11,364)
Proceeds from sale of loans held for sale	88,905	13,033
Change in operating accounts of discontinued operations	—	(2,540)
Gain on sale of discontinued operations	—	(6,083)
Net cash (used in) provided by operating activities	<u>(9,108)</u>	<u>4,555</u>
Investing activities:		
Changes in federal funds sold, net	—	24,000
Purchases of investment securities	(141,821)	(71,196)
Proceeds from sales of investment securities	14,209	106,450
Proceeds from maturities of investment securities	31,981	26,379
Purchases of Federal Reserve and Federal Home Loan Bank stock	(8,618)	(2,817)
Sales of Federal Reserve and Federal Home Loan Bank stock	7,547	2,902
Net (increase) decrease in participating interests in mortgage loans	(4,227)	31,768
Net increase in loans, excluding participating interests in mortgage loans	(61,511)	(164,143)
Proceeds from sales of ORE	222	—
Additions to bank premises and equipment	(2,990)	(1,889)
Proceeds from sales of bank premises and equipment	4,600	836
Proceeds from sale of insurance operations, net	—	35,204
Net cash used in investing activities	<u>(160,608)</u>	<u>(12,506)</u>

BNCCORP, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

Years ended December 31, 2008 and 2007

(In thousands)

	<u>2008</u>	<u>2007</u>
Financing activities:		
Net increase in deposits	\$ 133,448	12,622
Net increase (decrease) in short-term borrowings	11,479	(4,344)
Repayments of Federal Home Loan Bank advances	(3,413,530)	(320,200)
Proceeds from Federal Home Loan Bank advances	3,436,630	319,400
Repayments of long-term borrowings	—	(16,167)
Proceeds from long-term borrowings	—	15,000
Purchases of treasury stock	(2,598)	(1,720)
Net cash provided by financing activities	<u>165,429</u>	<u>4,591</u>
Net decrease in cash and cash equivalents	(4,287)	(3,360)
Cash and cash equivalents, beginning of year	<u>14,856</u>	<u>18,216</u>
Cash and cash equivalents, end of year	<u>\$ 10,569</u>	<u>14,856</u>
Supplemental cash flow information:		
Interest paid	\$ 15,892	21,981
Income taxes paid	2,231	3,367
Supplemental disclosure of noncash investing and financing activities:		
Additions to other real estate in settlement of loans	\$ 10,717	—

See accompanying notes to consolidated financial statements.

BNCCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

December 31, 2008 and 2007

(1) Description of Business and Significant Accounting Policies

Description of Business

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 subsidiaries, BNC Insurance Services, Inc., and BNC Asset Management, Inc., collectively, the Bank). BNCCORP and its subsidiaries (collectively, the Company) operates community banking and wealth management businesses in Arizona, Minnesota, and North Dakota from 20 locations. BNC also conducts mortgage banking from five locations in Iowa, Kansas, Missouri and Arizona.

The consolidated financial statements included herein are for the Company. The accounting and reporting policies of the Company conform to U.S. generally accepted accounting principles and general practices within the financial services industry. The more significant accounting policies are summarized below.

As used in this report, unless the context otherwise requires, the terms “we,” “us,” or “our” refers to the Company.

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of BNCCORP and its wholly owned subsidiaries. All significant intercompany transactions and balances have been eliminated in consolidation.

Use of Estimates

The preparation of consolidated financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Ultimate results could differ from those estimates.

(a) Critical Accounting Policies

Critical accounting policies are dependent on estimates that are particularly susceptible to significant change and include the determination of the allowance for credit losses, income taxes, other than temporary impairment and fair value. The following have been identified as “critical accounting policies”.

Allowance for Credit Losses

The Bank maintains an estimate of its allowance for credit losses at a level considered adequate to provide for probable losses related to specifically identified loans as well as the remaining loan and lease portfolio that have been incurred as of each balance sheet date. The loan and lease portfolio and other credit exposures are reviewed regularly to evaluate the adequacy of the allowance for credit losses. The Bank evaluates the allowance necessary for specific nonperforming loans and also estimates losses in other credit exposures.

BNCCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

December 31, 2008 and 2007

The resultant three allowance components are as follows:

Specific Reserves – The amount of specific reserves is determined through a loan-by-loan analysis of problem loans over a minimum size. Included in problem loans are those nonaccrual or renegotiated loans that meet the criteria as being “impaired” under the definition in Statement of Financial Accounting Standards (SFAS) No. 114, *Accounting by Creditors for Impairment of a Loan*. A loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. Any allowance on impaired loans is generally based on one of three methods, as SFAS No. 114 requires that impaired loans be measured at either the present value of expected cash flows at the loan’s effective interest rate, the loan’s observable market price or the fair value of the collateral of the loan. Problem loans also include those credits that have been internally classified as credits requiring management’s attention due to underlying problems in the borrower’s business or collateral concerns.

Reserves for Homogeneous Loan Pools – The Bank makes a significant number of loans and leases that, due to their underlying similar characteristics, are assessed for loss as “homogeneous” pools. Included in the homogeneous pools are consumer loans and commercial loans under a certain size which have been excluded from the specific reserve allocation as previously discussed. The Bank segments the homogeneous pools by type of loan or lease and, using historical loss information, estimates a loss reserve for each pool.

Qualitative Reserve – The Bank’s senior lending management also allocates reserves for special circumstances which are unique to the measurement period. These include, among other things, prevailing trends and economic conditions in certain geographic, industry or lending segments of the portfolio; management’s assessment of credit risk inherent in the loan portfolio, delinquency data; historical loss experience and peer-group loss history.

Continuous credit monitoring and analysis of loss components are the principal processes relied upon by management to determine changes in estimated credit losses are reflected in the Bank’s allowance for credit losses on a timely basis. Management also considers experience of peer institutions and regulatory guidance in addition to the Bank’s own experience. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the allowance for credit losses. Such agencies may require additions to the allowance based on their judgment about information available to them at the time of their examination.

Loans, leases and other extensions of credit deemed uncollectible are charged to the allowance. Subsequent recoveries, if any, are credited to the allowance. Management’s estimate of the allowance for credit losses is highly dependent upon variables affecting valuation, including appraisals of collateral, evaluations of performance and status, and the amounts and timing of future cash flows expected to be received on impaired loans. These variables are reviewed periodically. Actual losses may vary from the current estimated allowance for credit losses. The provision for credit losses is the amount necessary to adjust the allowance to the level determined appropriate through application of the above processes.

BNCCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

December 31, 2008 and 2007

Our methodology incorporates a variety of risk considerations, both quantitative and qualitative, in establishing an allowance for credit losses that we believe is appropriate at each reporting date. Quantitative factors include our historical loss experience, delinquency and charge-off trends, collateral values, changes in nonperforming loans and other factors. Quantitative factors also incorporate known information about individual loans, including borrowers' sensitivity to interest rate movements and borrowers' sensitivity to quantifiable external factors that occur in a particular period.

Qualitative factors include the general economic environment in our markets and the state of certain industries in our market areas. Size and complexity of individual credits, loan structure, the extent and nature of waivers of loan policies and pace of portfolio growth are other qualitative factors that are considered in our methodology.

Our methodology is, and has been, consistently applied. However, we will enhance our methodology as circumstances dictate to keep pace with the complexity of the loan and lease portfolio. We believe that our systematic methodology is appropriate given our size and level of complexity.

Income Taxes

The Company files consolidated federal and unitary state income tax returns. Deferred income taxes are accounted for using the asset and liability method. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Such differences can relate to differences in accounting for credit losses, depreciation, unrealized gains and losses on investment securities, deferred compensation and leases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

The determination of current and deferred income taxes is based on complex analyses of many factors including interpretation of federal and state income tax laws, the difference between tax and financial reporting basis of assets and liabilities (temporary differences), estimates of amounts due or owed such as the timing of reversals of temporary differences and current financial accounting standards. Actual results could differ significantly from the estimates and interpretations used in determining the current and deferred income taxes.

The Company adopted Financial Accounting Standards Board (FASB) Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*, on January 1, 2007. FIN 48 is an interpretation of SFAS No. 109, *Accounting for Income Taxes*, and it seeks to reduce the diversity in practice associated with certain aspects of measurement and recognition in accounting for income taxes. FIN 48 requires that the Company recognize in its financial statements, the impact of a tax position if that position is more likely than not of being sustained on audit based on the technical merits of the position. The adoption of FIN 48 did not have a material impact on the Company's results of operations or financial position. See Note 24 to these consolidated financial statements for additional information.

BNCCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

December 31, 2008 and 2007

Other than Temporary Impairment

Declines in the fair value of individual available-for-sale or held-to-maturity securities below their cost, which are deemed other than temporary, could result in a charge to earnings and the corresponding establishment of a new cost basis for the security. Such write-downs would be included in noninterest income as realized losses. The Company assesses available information regarding the collectibility of securities such as past events, current conditions and reasonable and supportable forecasts. Consideration is also given to a variety of factors including, but not limited to, the following:

- Recent and expected performance of the securities;
- Financial condition of issuers or guarantors;
- Recent cash flows;
- Seniority of invested tranches and subordinated credit support;
- Vintage of origination;
- Location of collateral;
- Ratings of securities;
- Value of underlying collateral;
- Delinquency and foreclosure data;
- Historical losses and estimated severity of future losses;
- Credit surveillance data which summarize retrospective performance; and
- Anticipated future cash flows and prospective performance assessments.

Determining whether an other than temporary impairment has occurred requires management's judgment of factors that may indicate an impairment loss has been incurred. There were no securities that management concluded were other than temporarily impaired in either 2008 or 2007.

Note 4 to these consolidated financial statements includes a summary of investment securities in a loss position at December 31, 2008 and a discussion concerning such securities.

Fair Value

Several accounting standards require recording assets and liabilities based on their fair values. Determining the fair value of assets and liabilities can be highly subjective.

SFAS No. 157, *Fair Value Measurements*, (SFAS 157) 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.

BNCCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

December 31, 2008 and 2007

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.

Management assigns a level to assets and liabilities accounted for at fair value and uses the methodologies prescribed by SFAS 157 to determine fair value.

(b) *Other Significant Accounting Policies*

Investment Securities

Investment securities that the Bank intends to hold for indefinite periods of time as part of its asset/liability strategy, or that may be sold in response to changes in interest rates, changes in prepayment risk, the need to increase regulatory capital or similar factors are classified as available for sale. Available for sale securities are carried at market value. Net unrealized gains and losses, net of deferred income taxes, on investment and mortgage-backed securities available for sale are reported as a separate component of stockholders' equity until realized (see Comprehensive Income). All securities, other than the securities of the Federal Reserve Bank (FRB) and the Federal Home Loan Bank (FHLB), were classified as available for sale as of December 31, 2008 and 2007.

Investment securities that the Bank intends to hold until maturity are carried at cost, adjusted for amortization of premiums and accretion of discounts using a level yield method over the period to maturity. There were no such securities as of December 31, 2008 or 2007.

Premiums and discounts are amortized or accreted over the life of the related security as an adjustment to yield using the effective-interest method. Dividend and interest income is recognized when earned. Realized gains and losses on the sale of investment securities are determined using the specific-identification method and recognized in noninterest income on the trade date.

Federal Reserve Bank and Federal Home Loan Bank of Des Moines Stock

Investments in FRB and FHLB stock are carried at cost, which approximates fair value.

Loans Held For Sale

At December 31, 2007 loans held for sale were accounted for at the lower of cost or market.

BNCCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

December 31, 2008 and 2007

In 2008, loans held for sale were accounted for at fair value pursuant to the fair value option permitted by SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, (SFAS 159). We elected the fair value option for loans held for sale because they are economically hedged with forward sales commitments. We expect that changes in the fair value of loans held for sale and forward sales commitments will be offsetting. Adopting SFAS 159 had no impact on retained earnings.

For mortgage loans held for sale carried at fair value under SFAS 159, gains and losses from the initial measurement and subsequent changes in fair value are included in mortgage banking revenue.

Participating Interests in Mortgage Loans

The Bank purchases participating interests in mortgage loans owned by mortgage banking counterparties. The participating interests are generally outstanding for a short duration as funds are advanced to finance loans closed by the counterparties and are repaid when the counterparties sell the loans. The participating interests are stated at the aggregate amount of the loans financed by the counterparties. An allowance for losses is estimated on the participating interests and is included in the allowance for credit losses.

Loans and Leases

Loans and leases held for investment are stated at their outstanding principal amount net of unearned income, net of unamortized deferred fees and costs and an allowance for credit losses. Interest income is recognized on an accrual basis using the interest method prescribed in the loan agreement except when collectibility is in doubt.

Loans and leases, including loans that are considered to be impaired, are reviewed regularly by management and are placed on nonaccrual status when the collection of interest or principal is 90 days or more past due, unless the loan or lease is adequately secured and in the process of collection. When a loan or lease is placed on nonaccrual status, unless collection of all principal and interest is considered to be assured, uncollected interest accrued in prior years is charged off against the allowance for credit losses. Interest accrued in the current year is reversed against interest income in the current period. Interest payments received on nonaccrual loans and leases are generally applied to principal unless the remaining principal balance has been determined to be fully collectible. Accrual of interest is resumed when it can be determined that all amounts due under the contract are expected to be collected and the loan has exhibited a sustained level of performance, generally at least six months.

All impaired loans are measured at the present value of expected future cash flows discounted at the loan's initial effective interest rate. The fair value of collateral of an impaired collateral-dependent loan or an observable market price may be used as an alternative to discounting. If the measure of the impaired loan is less than the recorded investment in the loan, impairment will be recognized as a charge-off through the allowance for credit losses. A loan is considered impaired when it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. All loans are reviewed for impairment on an individual basis.

BNCCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

December 31, 2008 and 2007

Cash receipts on impaired loans, excluding impaired loans that are on nonaccrual status, are applied to principal except when the loan is well collateralized or there are other circumstances that support recognition of interest. Cash receipts on impaired loans that are on nonaccrual status are applied to principal.

Loan Origination Fees and Costs and Other Lending Fees

For loans and leases held for investment, origination fees and costs incurred to extend credit are deferred and amortized over the term of the loan as an adjustment to yield using the interest method, except where the net amount is immaterial.

The Company occasionally originates lines of credit where the customer is charged a nonusage fee if the line of credit is not used. In such instances, we periodically review use of lines on a retrospective basis and recognize nonusage fees in noninterest income.

Mortgage Servicing and Transfers of Financial Assets

The Bank sells loans to others on a nonrecourse basis. Sold loans are not included in the accompanying consolidated balance sheets. 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. At December 31, 2008 and 2007, the Bank was servicing loans for the benefit of others with aggregate unpaid principal balances of \$315.5 million and \$201.8 million, respectively. In 2008 and 2007, \$285.6 million and \$187.5 million, respectively, of loans sold by the Bank are commercial lines of credit, or construction loans, for which balances and related payment streams cannot be reasonably estimated in order to determine the fair value of the servicing assets or liabilities and/or future interest income retained by the Bank. Upon sale, unearned net loan fees and/or costs are recognized in noninterest income and included in gains on sale of loans.

The sales of loans are accounted for pursuant to SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities*.

Premises and Equipment

Land is carried at cost. Premises and equipment are reported at cost less accumulated depreciation and amortization. Depreciation and amortization for financial reporting purposes is charged to operating expense using the straight-line method over the estimated useful lives of the assets. Estimated useful lives are up to 40 years for buildings and three to 10 years for furniture and equipment. Leasehold improvements are amortized over the shorter of the lease term or the estimated useful life of the improvement. The costs of improvements are capitalized. Maintenance and repairs, as well as gains and losses on dispositions of premises and equipment, are included in noninterest income or expense as incurred.

Other Real Estate Owned and Repossessed Property

Real estate properties and other assets acquired through loan foreclosures are stated at the lower of carrying amount or fair value less estimated costs to sell. When an asset is acquired, the excess of the recorded investment in the asset over fair value less estimated costs to sell, if any, is charged to the allowance for credit losses. Management performs valuations periodically. Fair value is generally

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determined based upon appraisals of the assets involved. Subsequent declines in the estimated fair value, net operating results and gains and losses on disposition of the asset are included in other noninterest income. Operating expenses of properties are charged to other real estate (ORE) expense.

Impairment of Long-Lived Assets

The Company reviews long-lived assets, including property and equipment, for impairment periodically or whenever events or changes in circumstances indicate that the carrying amount of any such asset may not be recoverable. If impairment is identified, the assets are written down to their fair value through a charge to noninterest expense. No such impairment losses were recorded during 2008 or 2007.

Long-Lived Assets Held for Sale

Long-lived assets held for sale are carried at the lower of the carrying amount or fair value less costs to sell. Assets classified as long-lived assets held for sale are available for immediate sale in their present condition and are actively marketed for sale. The Company does not record depreciation expense on long-lived assets held for sale.

Securities Sold under Agreements to Repurchase

From time to time, the Bank enters into sales of securities under agreements to repurchase, generally for periods of less than 90 days. These agreements are treated as financings, and the obligations to repurchase securities sold are reflected as a liability in the consolidated balance sheets as short-term borrowings. The costs of securities underlying the agreements remain in the asset accounts.

Fair Values of Financial Instruments

The Company is required to disclose the estimated fair value of financial instruments for which it is practicable to estimate fair value. Fair value estimates are subjective in nature, involving uncertainties and matters of significant judgment and, therefore, cannot be determined with precision. Changes in assumptions could significantly affect the estimates. Nonfinancial instruments are excluded from fair value of financial instrument disclosure requirements. The following methods and assumptions are used by the Company in estimating fair value disclosures for its financial instruments, all of which are issued or held for purposes other than trading.

Cash and Cash Equivalents, Noninterest-Bearing Deposits and Demand Deposits – The carrying amounts approximate fair value due to the short maturity of the instruments. The fair value of deposits with no stated maturity, such as interest checking, savings and money market accounts, is equal to the amount payable on demand at the reporting date.

Investment Securities Available for Sale – The fair value of the Company's securities are 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.

Federal Reserve Bank and Federal Home Loan Bank Stock – The carrying amount of FRB and FHLB stock is their cost, which approximates fair value.

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Loans Held for Sale – The fair value of the Company’s loans held for sale was stated at the lower of cost or market value of the loans at December 31, 2007. In 2008, loans held for sale were accounted for at fair value pursuant to the fair value option permitted by SFAS No. 159 *The Fair Value Option for Financial Assets and Financial Liabilities*. See recently issued or adopted accounting pronouncement disclosure.

Participating Interests in Mortgage Loans, Loans and Leases Held for Investment – Fair values of these assets are estimated by discounting future cash flow payment streams using rates at which current loans to borrowers with similar credit ratings and similar loan maturities are being made.

Accrued Interest Receivable – The fair value of accrued interest receivable equals the amount receivable due to the current nature of the amounts receivable.

Derivative Financial Instruments – The fair value of the Company’s derivatives are 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.

Interest-Bearing Deposits – Fair values of interest-bearing deposit liabilities are estimated by discounting future cash flow payment streams using rates at which comparable current deposits with comparable maturities are being issued. The intangible value of long-term customer relationships with depositors is not taken into account in the fair values disclosed.

Borrowings and Advances – The carrying amount of short-term borrowings approximates fair value due to the short maturity and the instruments’ floating interest rates, which are tied to market conditions. The fair values of long-term borrowings are estimated by discounting future cash flow payment streams using rates at which comparable borrowings are currently being offered.

Accrued Interest Payable – The fair value of accrued interest payable equals the amount payable due to the current nature of the amounts payable.

Guaranteed Preferred Beneficial Interests in Company’s Subordinated Debentures – The fair values of the Company’s subordinated debentures are estimated by discounting future cash flow payment streams using discount rates estimated to reflect those at which comparable instruments could currently be offered.

Financial Instruments with Off-Balance-Sheet Risk – The fair values of the Company’s commitments to extend credit and commercial and standby letters of credit are estimated using fees currently charged to enter into similar agreements.

Derivative Financial Instruments

SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended and interpreted, establishes accounting and reporting standards for derivative instruments, including

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certain derivative instruments embedded in other contracts, and for hedging activities. As required by SFAS No. 133, the Company records all derivatives at fair value.

The accounting for changes in the fair value of derivatives depends on the intended use of the derivative and the resulting designation. Derivatives used to hedge the exposure to variability in expected future cash flows, or other types of forecasted transactions, are considered cash flow hedges.

All derivative instruments that qualify for specific hedge accounting are recorded at fair value and classified either as a hedge of the fair value of a recognized asset or liability (fair value hedge) or as a hedge of the variability of cash flows to be received or paid related to a recognized asset or liability or a forecasted transaction (cash flow hedge). All relationships between hedging instruments and hedged items are formally documented, including the risk management objective and strategy for undertaking various hedge transactions. This process includes linking all derivatives that are designated as hedges to specific assets or liabilities on the balance sheet.

Changes in the fair value of a derivative that is highly effective and designated as a fair value hedge and the offsetting changes in the fair value of the hedged item are recorded in income. Changes in the fair value of a derivative that is highly effective and designated as a cash flow hedge are recognized in other comprehensive income until income from the cash flows of the hedged item are recognized. The Company performs an assessment, both at the inception of the hedge and on a quarterly basis thereafter, to determine whether these derivatives are highly effective in offsetting changes in the value of the hedged items. Any change in fair value resulting from hedge ineffectiveness is immediately recorded in income.

Revenue Recognition

The Company recognizes revenue on an accrual basis for interest and dividend income on loans, investment securities, Federal funds sold and interest-bearing cash and cash equivalent accounts. Noninterest income is recognized when it has been realized and has been earned. In accordance with existing accounting and industry standards, the Company considers revenue to be realized or realizable and earned when the following criteria have been met: persuasive evidence of an arrangement exists (generally, there is contractual documentation); delivery has occurred or services have been rendered; the seller's price to the buyer is fixed or determinable; and collectibility is reasonably assured. Additionally, there can be no outstanding contingencies that could ultimately cause the revenue to be passed back to the payor. In instances where these criteria have not been met, receipts are deferred until such time as they can be recognized as revenue.

Earnings Per Common Share

Basic earnings per share (EPS) excludes dilution and is computed by dividing income available to common stockholders by the weighted average number of common shares outstanding during the applicable period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the entity. Such potential dilutive instruments include stock options and contingently issuable stock. Note 25 to these consolidated financial statements includes disclosure of the Company's EPS calculations.

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Comprehensive Income

Comprehensive income is the total of net income and other comprehensive income, which for the Company, is generally comprised of unrealized gains and losses on securities available for sale and unrealized gains and losses on hedging instruments qualifying for cash flow hedge accounting treatment pursuant to SFAS No. 133, as amended. The Company presents consolidated statements of comprehensive income.

Cash and Cash Equivalents

For purposes of the Consolidated Statements of Cash Flows, cash and cash equivalents include cash on hand, cash due from banks and federal funds sold.

Share-Based Compensation

As of January 1, 2006, the Company adopted SFAS No. 123 (revised 2004), *Share-Based Payment* (FAS 123R), which requires the Company to measure the cost of employee services received in exchange for an award of equity instruments based on the fair value of the award on the grant date.

At December 31, 2008, the Company had three stock-based employee compensation plans, which are described more fully in Note 28 to these consolidated financial statements.

(c) Recently Issued or Adopted Accounting Pronouncements

The Company adopted FIN 48 on January 1, 2007. FIN 48 is an interpretation of SFAS No. 109, *Accounting for Income Taxes*, and it seeks to reduce the diversity in practice associated with certain aspects of measurement and recognition in accounting for income taxes. FIN 48 requires that the Company recognize in its financial statements, the impact of a tax position if that position is more likely than not of being sustained on audit based on the technical merits of the position. The adoption of FIN 48 did not have a material impact on the Company's results of operations or financial position. See Note 24 to these consolidated financial statements for additional information.

Emerging Issues Task Force (EITF) 06-04, *Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements* (EITF 06-04), requires recognition of a liability for future benefits in accordance with SFAS No. 106, *Employers Accounting for Post Retirement Benefits Other Than Pension* (if, in substance, a postretirement benefit plan exists), or Accounting Principles Board (APB) Opinion 12, *Deferred Compensation Contracts*, (if the arrangement is, in substance, an individual deferred compensation contract) based on the substantive agreement with the employee. The EITF is effective for fiscal years beginning after December 15, 2007, with earlier application permitted. The Company adopted EITF 06-04 on January 1, 2008 and recognized a cumulative-effect adjustment to decrease retained earnings by \$219,000.

SFAS No. 156, *Accounting for Servicing of Financial Assets – an amendment of SFAS No. 140*, requires an entity to recognize a servicing asset or liability each time it undertakes an obligation to service a financial asset. SFAS No. 156 requires that all separately recognized servicing assets and liabilities be initially measured at fair value and permits, but does not require the subsequent measurement of servicing assets and liabilities at fair value. The provisions of SFAS No. 156 were

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adopted by the Company on January 1, 2007 and did not have a material impact on the Company's results of operations or financial position. The Company elected to measure the subsequent measurements of the servicing assets and liabilities using the amortization method.

In September 2006, the FASB issued SFAS 157. This Statement defines fair value, establishes a framework for measuring fair value in U.S. generally accepted accounting principles, and expands disclosures about the use of fair value to measure assets and liabilities. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007. The impact of adopting SFAS 157 on January 1, 2008 did not have a material impact on the Company's results of operations or financial position. In accordance with the provisions of FASB Staff Position, or FSP, No. FAS 157-2, *Effective Date of FASB Statement No. 157*, we elected to defer implementation of SFAS 157, as it relates to our nonfinancial assets and nonfinancial liabilities that are recognized and disclosed at fair value in our consolidated financial statements on a nonrecurring basis, until January 1, 2009. We are evaluating the impact, if any, the adoption of SFAS 157 for our nonfinancial assets and nonfinancial liabilities will have on our financial position, results of operations or liquidity.

In February 2007, FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, including an amendment of SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. This Statement permits entities to measure many financial instruments and other items at fair value and most of the provisions of the Statement apply only to entities that elect the fair value option. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007. The impact of adopting SFAS No. 159 on January 1, 2008 had no impact on retained earnings.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51*. This Statement amends Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*, to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. It clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements. This Statement applies to all for-profit entities that prepare consolidated financial statements, but affects only those entities that have an outstanding noncontrolling interest in subsidiaries or that deconsolidate a subsidiary. This Statement is effective for financial statements issued for fiscal years beginning after December 15, 2008, and for interim periods within those fiscal years. The impact of adopting SFAS No. 160 on January 1, 2009 had no impact on the Company's results of operations or financial position.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations*. This Statement replaces SFAS No. 141, *Business Combinations*, and retains the fundamental requirements of SFAS No. 141 that the purchase method of accounting be used for all business combinations and for an acquirer to be identified for each business combination. This Statement established principles and requirements for how the acquirer recognizes and measures the assets acquired (including goodwill), the liabilities assumed, and any controlling interest in the acquiree. It also determines what information is to be disclosed to enable users of the financial statements to evaluate the nature and financial effect of the business combination. This Statement is effective for financial statements

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issued for fiscal years beginning after December 15, 2008, and for interim periods within those fiscal years.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities – an amendment of FASB Statement No. 133*. This Statement applies to all entities and requires enhanced disclosures about an entity's derivative hedging activities including how and why an entity uses derivative instruments, how derivative instruments and related hedged items are accounted for under SFAS No. 133 and how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. This Statement is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. We have not completed our analysis of the Statement but we believe the impact of adopting SFAS No. 161 on January 1, 2009 will not have a material impact on the Company's results of operations or financial position.

(d) Regulatory Environment

BNCCORP and its subsidiaries are subject to regulations of certain state and federal agencies, including periodic examinations by those regulatory agencies. BNCCORP and the Bank are also subject to minimum regulatory capital requirements. At December 31, 2008, capital levels exceeded minimum capital requirements. See Note 18 to these consolidated financial statements.

(e) Reclassifications

Certain amounts in the financial statements for the prior year have been reclassified to conform to the current year's presentation. These reclassifications had no effect on net income or stockholders' equity.

(2) Acquisitions and Divestitures

On June 1, 2007, the Company completed the sale of substantially all of the assets of BNC Insurance Services, Inc. (BNC Insurance). Management considered the benefits of the sale including, but not limited to the following:

- Monetizes the value of a segment the Company had nurtured;
- Strengthens the regulatory capital of Company;
- Decreases the risk of impaired revenue due to a decline in contingency income;
- Decreases exposure to the cyclicity of the insurance business; and
- Permits replacement of a significant portion of the income generated by the agency.

The Company initiated actions related to the sale late in 2006 and reached an agreement to sell substantially all of the assets of the insurance segment in March 2007. Stockholders approved the transaction in May 2007. The gross proceeds from sale were \$37.250 million and a pre-tax gain on sale of \$6.083 million was recognized in the second quarter of 2007.

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The financial statements of the Company report BNC Insurance in discontinued operations for all periods presented. The gain on sale is also reported in discontinued operations of the Company in 2007. Pre-tax revenues of BNC Insurance were \$9.111 million in 2007.

(3) Restrictions on Cash and Cash Equivalents

The Bank is required to maintain reserve balances in cash on hand or with the FRB under the Federal Reserve Act and FRB's Regulation D required reserve balances were \$25,000 as of December 31, 2008 and 2007.

(4) 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 December 31, 2008 or 2007. The carrying amount of available-for-sale securities and their approximate fair values were as follows as of December 31 (in thousands):

	2008			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value
U.S. government agency mortgage-backed securities guaranteed by GNMA	\$ 1,505	39	(1)	1,543
U.S. government agency mortgage-backed securities issued by FNMA	2,891	33	(7)	2,917
Collateralized mortgage obligations guaranteed by GNMA	23,037	177	(44)	23,170
Collateralized mortgage obligations issued by FNMA or FHLMC	37,896	1,128	—	39,024
Other collateralized mortgage obligations	138,851	233	(9,899)	129,185
State and municipal bonds	13,482	541	(5)	14,018
	\$ 217,662	2,151	(9,956)	209,857

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	2007			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value
U.S. government agency mortgage-backed securities guaranteed by GNMA	\$ 1,799	1	(16)	1,784
U.S. government agency mortgage-backed securities issued by FNMA	3,329	33	(29)	3,333
Collateralized mortgage obligations guaranteed by GNMA	2,394	19	—	2,413
Collateralized mortgage obligations issued by FNMA or FHLMC	62,384	933	(11)	63,306
Other collateralized mortgage obligations	32,830	312	(63)	33,079
State and municipal bonds	17,885	1,099	—	18,984
	\$ 120,621	2,397	(119)	122,899

The amortized cost and estimated fair market value of available-for-sale securities classified according to their contractual maturities at December 31, 2008, were as follows (in thousands):

	Amortized cost	Estimated fair value
Due in one year or less	\$ 2,480	2,527
Due after one year through five years	6,285	6,430
Due after five years through ten years	38,801	38,648
Due after ten years	170,096	162,252
Total	\$ 217,662	209,857

Securities carried at approximately \$197.5 million and \$118.3 million at December 31, 2008 and 2007, respectively, were pledged as collateral for public and trust deposits and borrowings, including borrowings from the FHLB and repurchase agreements with customers.

Sales proceeds and gross realized gains and losses on available-for-sale securities were as follows for the years ended December 31 (in thousands):

	2008	2007
Sales proceeds	\$ 14,209	106,450
Gross realized gains	256	—
Gross realized losses	(9)	(3,277)

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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 at December 31, 2008 and 2007 (in thousands):

Description of securities	December 31, 2008								
	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	—	\$ —	—	1	\$ 81	(1)	1	\$ 81	(1)
U.S. government agency mortgage-backed securities issued by FNMA	—	—	—	3	1,555	(7)	3	1,555	(7)
Collateralized mortgage obligations guaranteed by GNMA	2	10,402	(44)	—	—	—	2	10,402	(44)
Other collateralized mortgage obligations	26	109,322	(9,767)	1	2,490	(132)	27	111,812	(9,899)
State and municipal bonds	2	892	(5)	—	—	—	2	892	(5)
Total temporarily impaired securities	<u>30</u>	<u>\$ 120,616</u>	<u>(9,816)</u>	<u>5</u>	<u>\$ 4,126</u>	<u>(140)</u>	<u>35</u>	<u>\$ 124,742</u>	<u>(9,956)</u>

Description of securities	December 31, 2007								
	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	—	\$ —	—	3	\$ 1,399	(16)	3	\$ 1,399	(16)
U.S. government agency mortgage-backed securities issued by FNMA	—	—	—	5	2,194	(29)	5	2,194	(29)
Collateralized mortgage obligations issued by FNMA or FHLMC	2	514	(2)	2	2,499	(9)	4	3,013	(11)
Other collateralized mortgage obligations	3	11,704	(63)	—	—	—	3	11,704	(63)
State and municipal bonds	—	—	—	—	—	—	—	—	—
Total temporarily impaired securities	<u>5</u>	<u>\$ 12,218</u>	<u>(65)</u>	<u>10</u>	<u>\$ 6,092</u>	<u>(54)</u>	<u>15</u>	<u>\$ 18,310</u>	<u>(119)</u>

In reaching the conclusion that the impairments disclosed in the tables above are temporary and not other-than-temporary in nature, the Company considered the nature of the securities, the associated guarantees and collateralization, the securities ratings and the level of impairment of the securities. As of December 31, 2008, there were nine U.S. government agency mortgage-backed securities with unrealized losses, four issued and guaranteed by GNMA, the other five by FNMA or FHLMC, and there were two general obligation bank-qualified, municipal bonds with underlying ratings of "A" or above.

The 27 other collateralized mortgage obligations that were in an unrealized loss position are senior tranches, backed by fixed-rate collateral generated in 2004 or earlier. All but one of these securities have been in an unrealized loss positions for less than twelve months. The weighted average amortized

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loan-to-value (LTV) of the collateral underlying 15 of the 27 securities in an unrealized loss position is less than 60%. The largest weighted average amortized LTV of any of the securities in an unrealized loss position is 70.4%. All but three of these securities were originally issued in 2003 or in the first half of 2004. The three securities in an unrealized loss position that were issued in 2005 are off of mortgage collateral that was originated in 2001, 2002, 2003 and 2004 and have collateral ages of 61, 63, and 79 months, respectively.

All of the securities are rated investment grade by Moody's, Standard & Poor's, and/or Fitch. Twenty-six of the 27 securities carry "AAA" ratings by two of the three ratings agencies. None of the securities are currently "on-watch" for downgrade from their current ratings. None of the impairments were due to deterioration in credit quality that might result in the noncollection of contractual principal and interest. The cause of the impairments is, in general, attributable to changes in interest rates. Further, we have both the intent and ability to hold these impaired securities for a sufficient period of time to allow for their recovery in market value. For management's conclusion on other than temporary impairment, refer to the other than temporary impairment discussion in the critical accounting policies in Note 1 to these consolidated financial statements.

(5) Federal Reserve Bank and Federal Home Loan Bank of Des Moines Stock

The carrying amounts of FRB and FHLB stock, which approximate their fair values, consisted of the following as of December 31 (in thousands):

	<u>2008</u>	<u>2007</u>
Federal Reserve Bank Stock, at cost	\$ 1,297	1,297
Federal Home Loan Bank of Des Moines Stock, at cost	4,692	3,621
Total	<u>\$ 5,989</u>	<u>4,918</u>

There is no contractual maturity on these investments; they represent required investments.

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(6) Loans and Leases

Loan Portfolio Composition

The composition of loans and leases, including participating interests in mortgage loans, classified as we present on our regulatory reports was as follows at December 31 (in thousands):

	<u>2008</u>	<u>2007</u>
Commercial and industrial	\$ 138,671	125,555
Real estate:		
Mortgage	265,360	181,000
Construction	108,713	167,345
Agricultural	22,023	17,074
Consumer	6,873	5,445
Lease financing	1,287	1,815
Other	633	433
Subtotal	<u>543,560</u>	<u>498,667</u>
Participating interests in mortgage loans	<u>28,584</u>	<u>24,357</u>
Total gross loans held for investment	572,144	523,024
Unearned income and net unamortized deferred fees and costs	<u>(807)</u>	<u>(1,111)</u>
Loans, net of unearned income and unamortized fees and costs	571,337	521,913
Allowance for credit losses	<u>(8,751)</u>	<u>(6,599)</u>
Net loans and leases	<u>\$ 562,586</u>	<u>515,314</u>

Commercial and industrial loan borrowers are generally small and mid-sized corporations, partnerships and sole proprietors in a wide variety of businesses. Real estate loans are fixed or variable rate and include both amortizing and revolving line-of-credit loans. Real estate mortgage loans include various types of loans for which the Bank holds real property as collateral. Agricultural loans include loans to grain and/or livestock producers, agricultural real estate loans, machinery and equipment and other types of loans. Loans to consumers are both secured and unsecured. Lease financing represents credit to borrowers under direct finance lease obligations. The Bank also extends financing to lease companies, securing the loan with an assignment of lease payments and a security filing against the underlying asset of the lease. These loans are classified as lease financing but are not direct finance lease obligations.

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Concentrations of Credit

The following tables summarize the location of our borrowers as of December 31 (in thousands):

	2008		2007	
Minnesota	\$ 185,947	33%	\$ 193,149	37%
North Dakota	173,509	30	154,972	30
Arizona	145,643	25	136,371	26
Other	67,045	12	38,532	7
Totals	\$ 572,144	100%	\$ 523,024	100%

Our borrowers use loan proceeds for projects in various geographic areas. The following table summarizes the locations where our borrowers are using loan proceeds as of December 31 (in thousands):

	2008		2007	
North Dakota	\$ 181,073	32%	\$ 160,506	31%
Arizona	126,327	22	120,931	23
Minnesota	106,786	19	130,085	25
Texas	37,032	6	26,966	5
California	23,894	4	20,715	4
Kentucky	11,000	2	9,916	2
Wisconsin	10,301	2	5,573	1
Idaho	8,146	1	5,621	1
New York	7,496	1	4,155	1
Georgia	6,559	1	6,566	1
South Dakota	5,864	1	1,723	—
Arkansas	5,260	1	5,171	1
Florida	5,228	1	2,862	1
Other	37,178	7	22,234	4
Totals	\$ 572,144	100%	\$ 523,024	100%

The bank has a concentration of loans exceeding 10% of the total loan portfolio in real estate loans. Significant concentrations within the real estate portfolio as defined by the loan's purpose code as of December 31 are as follows (in thousands):

	2008		2007	
Land and land development loans	\$ 61,814	11%	\$ 78,992	15%
Construction loans	37,746	7	68,849	13
Totals	\$ 99,560	18%	\$ 147,841	28%

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Construction loans include loans for which construction is complete and the loans will be either sold or refinanced to permanent loans within the following year.

Impaired Loans

As of December 31, the Bank's recorded investment in impaired loans and the related valuation allowance was as follows (in thousands):

	2008		2007	
	Recorded investment	Valuation allowance	Recorded investment	Valuation allowance
Impaired loans:				
Valuation allowance required	\$ 17,355	1,619	16,397	1,572
No valuation allowance required	—	—	—	—
Total impaired loans	\$ 17,355	1,619	16,397	1,572

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 all loans risk-graded substandard and doubtful, as well as nonaccrual and restructured loans, as impaired loans.

The valuation allowance on impaired loans is included in the Bank's allowance for credit losses. The average recorded investment in impaired loans, and approximate interest income recognized for such loans, were as follows for the years ended December 31 (in thousands):

	2008	2007
Average recorded investment in impaired loans	\$ 17,917	16,228
Average recorded investment in impaired loans as a percentage of average total loans	3.41%	3.26%
	2008	2007
Interest income recognized on impaired loans	\$ 267	159
Interest income recognized on a cash basis during the time of impairment	169	18

Loans to Related Parties

Note 23 to these consolidated financial statements includes information relating to loans to executive officers, directors, principal shareholders and associates of such persons.

BNCCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

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Leases

The Bank extends credit to borrowers under direct finance lease obligations. The direct finance lease obligations are stated at their outstanding principal amount net of unearned income and net unamortized deferred fees and costs. At December 31, 2008, the future minimum annual lease payments for direct finance lease obligations were as follows (in thousands):

2009	\$	486
2010		258
2011		225
2012		24
2013		—
Thereafter		—
		<hr/>
Total future minimum lease payments		993
Unguaranteed residual values		414
		<hr/>
Total all payments		1,407
Unearned income		(120)
		<hr/>
Net outstanding principal amount	\$	<u>1,287</u>

Loans Pledged as Collateral

Single- and multi-family residential mortgage loans totaling \$12.2 million and \$11.7 million at December 31, 2008 and 2007, respectively, were pledged as collateral for borrowings. Commercial real estate first mortgage loans totaling \$58.2 million and \$68.5 million at December 31, 2008 and 2007, respectively, were pledged as collateral for borrowings. Home equity lines of credit, residential second mortgage loans, and warehouse mortgage loans held for sale of \$7.6 million, \$7.2 million, and \$10.7 million, respectively, as of December 31, 2008 were pledged as collateral for borrowings. No home equity lines of credit, residential second mortgage loans, and warehouse mortgage loans held for sale were pledged as collateral for borrowings as of December 31, 2007.

BNCCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

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(7) Allowance for Credit Losses

Transactions in the allowance for credit losses were as follows for the years ended December 31 (in thousands):

	<u>2008</u>	<u>2007</u>
Balance, beginning of year	\$ 6,599	3,370
Provision for credit losses	7,750	3,750
Loans charged off	(5,946)	(2,127)
Loans recovered	348	1,606
Balance, end of year	<u>\$ 8,751</u>	<u>6,599</u>

(8) 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. The property is evaluated regularly and any decreases in the carrying amount are included in noninterest expense. ORE consisted of the following at December 31 (in thousands):

	<u>2008</u>	<u>2007</u>
Other real estate:		
Other real estate owned	\$ 10,189	—
Real estate in judgment	—	—
In-substance foreclosure	—	—
Total other real estate owned	10,189	—
Allowance for other real estate losses	—	—
Total other real estate owned, net	<u>\$ 10,189</u>	<u>—</u>

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(9) Premises and Equipment, Net

Premises and equipment, net consisted of the following at December 31 (in thousands):

	<u>2008</u>	<u>2007</u>
Land and improvements	\$ 6,692	6,692
Buildings and improvements	12,914	11,108
Leasehold improvements	1,795	1,686
Furniture, fixtures and equipment	<u>8,643</u>	<u>8,085</u>
Total cost	30,044	27,571
Less accumulated depreciation and amortization	<u>(9,234)</u>	<u>(8,123)</u>
Net premises, leasehold improvements and equipment	<u>\$ 20,810</u>	<u>19,448</u>

Depreciation and amortization expense charged to continuing operations totaled approximately \$1.4 million and \$1.6 million for the years ended December 31, 2008 and 2007, respectively.

(10) Premises and Equipment Held for Sale

In October 2007, the Company entered into an exclusive listing agreement with a commercial real estate broker to sell a commercial building which was no longer needed for operating purposes. The Company sold the building in the second quarter of 2008 and recognized a gain of \$832,000.

(11) Deposits

The scheduled maturities of time deposits as of December 31, 2008 are as follows (in thousands):

2009	\$ 234,695
2010	54,395
2011	12,440
2012	22,305
2013	10,183
Thereafter	<u>5,456</u>
	<u>\$ 339,474</u>

At December 31, 2008 and 2007, the Bank had \$99.7 million and \$30.0 million, respectively, of time deposits that had been acquired through a broker.

Deposits Received from Related Parties

Note 23 to these consolidated financial statements includes information relating to deposits received from executive officers, directors, principal shareholders and associates of such persons.

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(12) Short-Term Borrowings

The following table sets forth selected information for short-term borrowings (borrowings with an original maturity of less than one year) as of December 31 (in thousands):

	<u>2008</u>	<u>2007</u>
Federal funds purchased and U.S. Treasury tax and loan retainer	\$ 9,345	1,876
Repurchase agreements with customers, renewable daily, interest payable monthly, rates ranging from 0.25% to 1.70% in 2008, and 3.15% to 4.00%, in 2007, secured by government agency collateralized mortgage obligations	<u>7,499</u>	<u>3,489</u>
	<u>\$ 16,844</u>	<u>5,365</u>

The weighted average interest rate on short-term borrowings outstanding as of December 31, 2008 and 2007 was 0.88% and 3.64%, respectively.

Customer repurchase agreements are used by the Bank to acquire funds from customers where the customers are required, or desire, to have their funds supported by collateral consisting of government, government agency or other types of securities. The repurchase agreement is a promise to sell these securities to a customer at a certain price and repurchase them at a future date at that same price plus interest accrued at an agreed upon rate. The Bank uses customer repurchase agreements in its liquidity plan as well as an accommodation to customers. At December 31, 2008, \$7.5 million of securities sold under repurchase agreements, with a weighted average interest rate of 1.27%, maturing in 2009, were collateralized by government agency collateralized mortgage obligations having a carrying value of \$20.0 million, a market value of \$20.0 million and unamortized principal balances of \$19.5 million.

As of December 31, 2008, the Bank had established Federal funds purchase programs with two banks, totaling \$9 million. At December 31, 2008, the Bank had purchased Federal funds of \$7 million under these programs leaving \$2 million available. The Federal funds purchase programs, if advanced upon, mature daily with interest rates that float at the Federal funds rate.

BNCCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

December 31, 2008 and 2007

(13) Federal Home Loan Bank Advances

FHLB advances consisted of the following at December 31 (in thousands):

	2008		2007	
	Amount	Weighted average rate	Amount	Weighted average rate
Year of maturity:				
2008	\$ —	—%	\$ 61,400	4.26%
2009	62,500	0.91	—	—
2013	15,000	3.99	—	—
2015	7,000	5.16	—	—
	\$ 84,500	1.81%	\$ 61,400	4.26%

As of December 31, 2008, the Bank had \$62.5 million of FHLB advances maturing in January 2009. These advances were renewed in the normal course of business. The Bank retains the option to call the \$15 million advance maturing in 2013 without a prepayment penalty, on March 10, 2010 and quarterly thereafter. The Bank retains the option to call the \$7 million advance maturing in 2015 without a prepayment penalty, on July 17, 2009 and quarterly thereafter.

At December 31, 2008, the advances from the FHLB were collateralized by the Bank's mortgage loans with unamortized principal balances of approximately \$96.0 million resulting in a FHLB collateral equivalent of \$59.5 million. In addition, the advances from the FHLB were collateralized by securities with unamortized principal balances of approximately \$150.8 million. The Bank has the ability to draw additional advances of \$109.3 million based upon the mortgage loans and securities that are currently pledged, subject to a requirement to purchase additional FHLB stock.

(14) Long-Term Borrowings

As of December 31, 2008, BNCCORP had a \$20.0 million established line of credit with the Bank of North Dakota. Interest is payable quarterly at 30-day LIBOR plus 2.00%; maturity is February 15, 2010. No funds were drawn on the line as of December 31, 2008 or 2007.

(15) Guaranteed Preferred Beneficial Interest's in Company's Subordinated Debentures

In July 2007, BNCCORP established a special purpose trust, BNC Statutory Trust III, for the purpose of issuing \$15.0 million of floating rate trust preferred securities. The interest rate paid on the securities is equal to three-month LIBOR plus 1.4000%. The interest rate at December 31, 2008 was 5.2825% and the interest rate reset on January 2, 2009 to 2.8350%. The trust preferred securities mature on October 1, 2037. On or after October 1, 2012, the trust preferred securities may be redeemed at par and the corresponding debentures may be prepaid at the option of BNCCORP, subject to Federal Reserve Board approval.

BNC Statutory Trust III was used to refinance BNC Statutory Trust II. BNC Statutory Trust II securities had an outstanding balance of \$15.0 million and we incurred a prepayment penalty of \$1.189 million in 2007 when our obligation to BNC Statutory Trust II was settled.

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Notes to Consolidated Financial Statements

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In July 2000, BNCCORP established a special purpose trust, BNC Capital Trust I, for the purpose of issuing \$7.5 million of trust preferred securities at 12.045%. The trust preferred securities are subject to mandatory redemption on July 19, 2030. On or after July 19, 2010, the trust preferred securities may be redeemed and the corresponding debentures may be prepaid at the option of BNCCORP, subject to Federal Reserve Board approval, at declining redemption prices.

BNCCORP fully and unconditionally guarantees all obligations of the special purpose trusts related to the trust preferred securities.

(16) Stockholders' Equity

BNCCORP and the Bank are subject to certain minimum capital requirements (see Note 18 to these consolidated financial statements). BNCCORP is also subject to certain restrictions on the amount of dividends it may declare without prior regulatory approval in accordance with the Federal Reserve Act. In addition, certain regulatory restrictions exist regarding the ability of the Bank to transfer funds to BNCCORP in the form of cash dividends. Approval of the Office of the Comptroller of the Currency (OCC), the Bank's principal regulator, is required for the Bank to pay dividends to BNCCORP in excess of the Bank's net profits from the current year plus retained net profits for the preceding two years. At December 31, 2008, approximately \$961,000 of retained earnings were available for Bank dividend declaration without prior regulatory approval.

BNCCORP repurchased 200,326 shares of its common stock for \$2.6 million or \$13.03 per share in 2008. In 2007, the Company purchased 94,782 shares of its common stock for \$1.7 million or \$18.15 per share.

On May 30, 2001, BNCCORP's Board of Directors (the Board) adopted a rights plan intended to protect stockholder interests in the event BNCCORP becomes the subject of a takeover initiative that BNCCORP's Board believes could deny BNCCORP's stockholders the full value of their investment. This plan does not prohibit the Board from considering any offer that it deems advantageous to its stockholders. BNCCORP has no knowledge that anyone is considering a takeover.

The rights were issued to each common stockholder of record on May 30, 2001, and they will be exercisable only if a person acquires, or announces a tender offer that would result in ownership of, 15% or more of BNCCORP's outstanding common stock. The rights will expire on May 30, 2011, unless redeemed or exchanged at an earlier date.

(17) Derivatives

The Company entered into an interest rate floor agreement during the first quarter of 2006. The \$50.0 million prime rate interest rate floor has an effective date of January 9, 2006 and a maturity date of January 9, 2010. The floor is designated as a cash flow hedge. The terms of the floor result in the Company receiving payments when the prime interest rate is below the strike rate of 7.00%. At December 31, 2008, the prime rate was 3.25% and the Company was receiving payments under the terms of the agreement. At December 31, 2007, the prime rate was 7.25% and the Company was not entitled to receive a payment under the terms of the agreement. The floor was used to hedge the variable cash flows associated with \$50.0 million of the Company's existing variable-rate loans. In 2008, we received \$863,000 of payments on the floor.

BNCCORP, INC. AND SUBSIDIARIES

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At December 31, 2008, the fair value of the floor was \$1.9 million, which was included in other assets. The change in unrealized gain of \$1.3 million, net, during the year ended December 31, 2008, for the derivative designated as a cash flow hedge, is separately disclosed in the statement of changes in comprehensive income. There was \$105,000 of hedge ineffectiveness on the cash flow hedge that was recognized during the year. The entire gain on the derivative was included in the assessment of the effectiveness.

At December 31, 2007, the fair value of the floor was \$761,000, which was included in other assets. The change in unrealized gains of \$690,000, net, during the year ended December 31, 2007, for the derivative designated as a cash flow hedge, is separately disclosed in the statement of changes in comprehensive income. No hedge ineffectiveness on the cash flow hedge was recognized during the year. The entire gain on the derivative was included in the assessment of the effectiveness.

In our mortgage banking operations, the Company makes commitments to originate and sell loans. Commitments to originate and commitments to sell residential loans are considered to be derivatives pursuant to SFAS No. 133.

Commitments to originate and sell residential loans are entered into concurrently in order to create economic hedges for changes in interest rates. The commitments are not formally designated as hedges. Because the commitments are derivatives, the value of the commitments is recorded at fair value.

At December 31, 2008, the fair value of commitments to originate residential loans was \$429,000, which is recorded in other assets. The change in fair value of the commitment to originate loans in 2008 was \$429,000, and this change was recognized in the income statement.

At December 31, 2008, the fair value of the commitments to sell residential loans was \$697,000, which is recorded in other liabilities. The change in fair value of the commitments to sell residential loans in 2008 was \$697,000, and this change was recognized in the income statement.

At December 31, 2007, commitments to originate and sell residential loans were \$0 and the change in fair value of the commitment to originate loans was \$0.

(18) Regulatory Capital

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. Capital amounts and classifications of BNCCORP and the Bank are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Quantitative measures established by the regulations to ensure capital adequacy require BNCCORP and the Bank to maintain minimum amounts and ratios of total and Tier 1 capital to risk-weighted assets and of Tier 1 capital to average assets.

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Under current regulatory capital regulations, BNCCORP's subordinated debentures qualify as Tier 1 capital for purposes of the consolidated capital calculations up to 25% of Tier 1 capital prior to the deduction of intangible assets. The remainder of the subordinated debentures qualify as Tier 2 capital provided that the total of Tier 2 capital does not exceed Tier 1 capital. As of December 31, 2008, \$19.2 million of the subordinated debentures qualified as Tier 1 capital with the remaining \$3.8 million qualifying as Tier 2 capital. As of December 31, 2007, \$19.4 million of the subordinated debentures qualified as Tier 1 capital with the remaining \$3.7 million qualifying as Tier 2 capital.

As of December 31, 2008, the most recent notifications from the OCC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios as set forth in the table that follows. There are no conditions or events since that notification that management believes have changed the institution's category. Actual capital amounts and ratios of BNCCORP and the Bank as of December 31 are also presented in the tables (dollars in thousands):

	Actual		For capital adequacy		To be well capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
2008:						
Total capital (to risk-weighted assets):						
Consolidated	\$ 88,949	12.95%	\$ 54,943	≥8.0%	N/A	N/A
BNC National Bank	87,956	12.81	54,948	≥8.0	68,685	≥10.0%
Tier 1 capital (to risk-weighted assets):						
Consolidated	76,585	11.15	27,472	≥4.0	N/A	N/A
BNC National Bank	79,368	11.56	27,474	≥4.0	41,211	≥6.0%
Tier 1 capital (to average assets):						
Consolidated	76,585	9.01	33,994	≥4.0	N/A	N/A
BNC National Bank	79,368	9.34	33,982	≥4.0	42,478	≥5.0%
2007:						
Total capital (to risk-weighted assets):						
Consolidated	\$ 87,338	14.26%	\$ 48,991	≥8.0%	N/A	N/A
BNC National Bank	87,240	14.26	48,959	≥8.0	61,199	≥10.0%
Tier 1 capital (to risk-weighted assets):						
Consolidated	77,021	12.58	24,496	≥4.0	N/A	N/A
BNC National Bank	80,641	13.18	24,479	≥4.0	36,719	≥6.0%
Tier 1 capital (to average assets):						
Consolidated	77,021	12.01	25,648	≥4.0	N/A	N/A
BNC National Bank	80,641	12.57	25,668	≥4.0	32,085	≥5.0%

On January 16, 2009, BNC announced that it received net proceeds of approximately \$20.1 million through the sale of shares of nonvoting senior preferred stock to the U.S. Department of the Treasury under the Capital Purchase Program. The Treasury Department also received a warrant exercisable for shares of an additional class of BNCCORP, Inc. preferred stock which has an aggregate liquidation preference of approximately \$1.0 million. The Treasury Department exercised this warrant at the closing of the transaction. The proceeds of the sale will further increase the Company's capital ratios and strengthen its capital position.

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(19) Fair Value of Financial Instruments

The estimated fair values of the Company's financial instruments are as follows as of December 31 (in thousands):

	2008		2007	
	Carrying amount	Fair value	Carrying amount	Fair value
Assets:				
Cash and cash equivalents	\$ 10,569	\$ 10,569	\$ 14,856	\$ 14,856
Investment securities available for sale	209,857	209,857	122,899	122,899
Federal Reserve Bank and Federal Home Loan Bank of Des Moines stock	5,989	5,989	4,918	4,918
Loans held for sale	13,403	13,403	—	—
Participating interests in mortgage loans	28,584	28,584	24,357	24,357
Loans and leases held for investment, net	534,002	533,008	490,957	492,251
Accrued interest receivable	3,263	3,263	3,290	3,290
Derivative financial instruments	1,896	1,896	761	761
	807,563	\$ 806,569	662,038	\$ 663,332
Other assets	53,935		37,553	
	\$ 861,498		\$ 699,591	
Liabilities and Stockholders' equity:				
Deposits, noninterest-bearing	\$ 68,996	\$ 68,996	\$ 72,234	\$ 72,234
Deposits, interest-bearing	606,325	608,275	469,640	470,297
Borrowings and advances	101,344	101,833	66,765	66,760
Accrued interest payable	1,679	1,679	2,843	2,843
Guaranteed preferred beneficial interests in Company's subordinated debentures	23,025	12,382	23,075	20,906
	801,369	\$ 793,165	634,557	\$ 633,040
Other liabilities	6,182		5,304	
Stockholders' equity	53,947		59,730	
	\$ 861,498		\$ 699,591	

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Notes to Consolidated Financial Statements

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	2008		2007	
	Carrying amount	Fair value	Carrying amount	Fair value
Financial instruments with off-balance-sheet risk:				
Commitments to extend credit	\$	300	\$	562
Standby and commercial letters of credit		65		91
Mortgage banking commitments to fund loans		26,343		—
Mortgage banking commitments to sell loans		<u>13,832</u>		<u>—</u>
	\$	<u>40,540</u>	\$	<u>653</u>

(20) Fair Value Measurements

The following table summarizes the financial assets and liabilities of the Company for which fair values are determined on a recurring basis as of December 31, 2008 (in thousands):

	Total	Level 1	Level 2	Level 3
Assets:				
Securities available for sale	\$ 209,857	—	209,857	—
Loans held for sale	13,403	—	13,403	—
Commitments to originate mortgage loans	429	—	429	—
Interest rate floor	<u>1,896</u>	<u>—</u>	<u>1,896</u>	<u>—</u>
Total assets at fair value	\$ <u>225,585</u>	<u>—</u>	<u>225,585</u>	<u>—</u>
Liabilities:				
Commitments to sell mortgage loans	\$ <u>697</u>	<u>—</u>	<u>697</u>	<u>—</u>
Total liabilities at fair value	\$ <u>697</u>	<u>—</u>	<u>697</u>	<u>—</u>

Changes in the fair value of assets and liabilities determined on a recurring basis had no net impact on our Consolidated Statement of Income for the year ended December 31, 2008. See Note 1 to these consolidated financial statements for definitions of Level 1, Level 2 and Level 3 inputs.

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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 that were still held at December 31, 2008, the following table provides the level of valuation assumptions used to determine each adjustment and the carrying value of the related individual assets or portfolios as of December 31, 2008 (in thousands):

	Carrying value at December 31, 2008			
	Total	Level 1	Level 2	Level 3
Impaired loans ⁽¹⁾	\$ 29,340	—	29,340	—
Total	\$ 29,340	—	29,340	—

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

(21) Financial Instruments with Off-Balance-Sheet Risk

In the normal course of business, the Company is a party to various financial instruments with off-balance-sheet risk, primarily to meet the needs of its customers as well as to manage its interest rate risk. These instruments, which are issued by the Company for purposes other than trading, carry varying degrees of credit, interest rate or liquidity risk in excess of the amounts reflected in the consolidated balance sheets.

Commitments to Extend Credit

Commitments to extend credit are agreements to lend to a customer, provided there is no violation of any condition in the contract, and are legally binding and generally have fixed expiration dates or other termination clauses and may require payment of a fee. The contractual amount represents the Bank's exposure to credit loss in the event of default by the borrower; however, at December 31, 2008, based on current information, no losses were anticipated as a result of these commitments. The Bank manages this credit risk by using the same credit policies it applies to loans. Collateral is obtained to secure commitments under contract based on management's credit assessment of the borrower. The collateral may include marketable securities, receivables, inventory, equipment or real estate. Since the Bank expects many of the commitments to expire without being drawn, total commitment amounts do not necessarily represent the Bank's future liquidity requirements related to such commitments.

In our mortgage banking operations, we commit to extend credit for purposes of selling residential loans. We underwrite these commitments to determine if each loan meets criteria established by the secondary market for residential loans. Forward commitments represent commitments to sell loans to third-party investors and are entered into in the normal course of business.

The Company's participating interests in mortgage loans are related to one counterparty relationship. As of December 31, 2008, there was a \$28.6 million limit to our loan commitment with this relationship.

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Standby and Commercial Letters of Credit

Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Commercial letters of credit are issued on behalf of customers to ensure payment or collection in connection with trade transactions. In the event of a customer's nonperformance, the Bank's credit loss exposure is the same as in any extension of credit, up to the letter's contractual amount. At December 31, 2008, based on current information, no losses were anticipated as a result of these commitments. Management assesses the borrower's credit to determine the necessary collateral, which may include marketable securities, real estate, accounts receivable, and inventory. Since the conditions requiring the Bank to fund letters of credit may not occur, the Bank expects our liquidity requirements related to such letters of credit to be less than the total outstanding commitments.

The contractual amounts of these financial instruments were as follows as of December 31 (in thousands):

	2008		2007	
	Fixed rate	Variable rate	Fixed rate	Variable rate
Commitments to extend credit	\$ 46,527	96,831	15,497	187,653
Standby and commercial letters of credit	244	6,265	273	8,859
Forward commitments	13,136	—	—	—

(22) Guarantees and Contingent Consideration

Guaranteed Preferred Beneficial Interests in Company's Subordinated Debentures

BNCCORP, concurrent with the issuance of preferred securities by BNC Capital Trust I and by BNC Statutory Trust III, fully and unconditionally guaranteed all obligations of the special purpose trusts related to the trust preferred securities. See Note 15 to these consolidated financial statements for a description of the trusts. There are no recourse provisions associated with these guarantees that would enable BNCCORP to recover from third parties any of the amounts paid under the guarantees and there are no assets held either as collateral or by third parties that, upon the occurrence of any triggering event or condition under the guarantees, BNCCORP could obtain and liquidate to recover all or a portion of the amounts paid under the guarantees.

Performance and Financial Standby Letters of Credit

As of December 31, 2008 and 2007, the Bank had outstanding \$4.3 million and \$4.8 million, respectively, of performance standby letters of credit and \$30.6 million and \$38.2 million, respectively, of financial standby letters of credit. Performance standby letters of credit are irrevocable obligations to the beneficiary on the part of the Bank to make payment on account of any default by the account party in the performance of a nonfinancial or commercial obligation. Financial standby letters of credit are irrevocable obligations to the beneficiary on the part of the Bank to repay money for the account of the account party or to make payment on account of any indebtedness undertaken by the account party, in the event that the account party fails to fulfill its obligation to the beneficiary. Under these arrangements, the Bank could, in the event of the account party's nonperformance, be required to pay a maximum of the amount of issued letters of credit. The Bank has recourse against the account party up to and including the amount of the performance

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standby letter of credit. The Bank evaluates each account party's creditworthiness on a case-by-case basis and the amount of collateral obtained varies and is based on management's credit evaluation of the account party.

(23) Related-Party/Affiliate Transactions

The Bank has entered into transactions with related parties, such as opening deposit accounts for and extending credit to, employees of the Company. In the opinion of management, such transactions have been fair and reasonable to the Bank and have been entered into under terms and conditions substantially the same as those offered by the Bank to unrelated parties.

In the normal course of business, loans are granted to, and deposits are received from, executive officers, directors, principal stockholders and associates of such persons. The aggregate dollar amount of these loans, which exceeded \$60,000, was \$2.2 million and \$1.9 million at December 31, 2008 and 2007, respectively. Originations in 2008 and 2007 totaled \$237,000 and \$1.5 million, respectively. Loan paydowns in 2008 and 2007 were \$28,000 and \$902,000, respectively. The total amount of deposits received from these parties was \$1.1 million and \$1.8 million at December 31, 2008 and 2007, respectively. Loans to, and deposits received from, these parties were made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with unrelated persons and do not involve more than the normal risk of collection.

The Federal Reserve Act limits amounts of, and requires collateral on, extensions of credit by the Bank to BNCCORP, and with certain exceptions, its nonbank affiliates. There are also restrictions on the amounts of investment by the Bank in stocks and other subsidiaries of BNCCORP and such affiliates and restrictions on the acceptance of their securities as collateral for loans by the Bank. As of December 31, 2008, BNCCORP and its affiliates were in compliance with these requirements.

(24) Income Taxes

The expense (benefit) for income taxes on continuing operations consists of the following for the years ended December 31 (in thousands):

	<u>2008</u>	<u>2007</u>
Continuing operations:		
Current:		
Federal	\$ 1,499	(1,133)
State	396	(270)
	<u>1,895</u>	<u>(1,403)</u>
Deferred:		
Federal	(958)	(1,057)
State	(200)	(268)
	<u>(1,158)</u>	<u>(1,325)</u>
Total from continuing operations	<u>\$ 737</u>	<u>(2,728)</u>

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Income tax expense on discontinued operations was \$3.067 million for the year ended December 31, 2007

The expense (benefit) for federal income taxes on continuing operations expected at the statutory rate differs from the actual expense (benefit) for the years ended December 31 (in thousands):

	2008	2007
Tax expense (benefit) at 34% statutory rate	\$ 1,005	(1,971)
State taxes (net of Federal benefit)	142	(262)
Tax-exempt interest	(267)	(283)
Increase in cash surrender values of bank-owned life insurance	(179)	(172)
Tax benefit as a result of the lapse of uncertain tax positions	(25)	(62)
Other, net	61	22
	\$ 737	(2,728)

Temporary differences between the financial statement carrying amounts and tax bases of assets and liabilities that result in significant portions of the Company's deferred tax assets and liabilities are as follows as of December 31 (in thousands):

	2008	2007
Deferred tax asset:		
Loans, primarily due to differences in accounting for credit losses	\$ 3,585	2,856
Difference between book and tax amortization of branch premium acquisition costs	117	206
Difference between book and tax amortization of acquired intangibles	37	59
Unrealized loss on securities available for sale	2,965	—
Expenses and write-downs on other real estate owned	904	—
Other	—	37
Deferred tax asset	7,608	3,158
Deferred tax liability:		
Unrealized gain on cash flow hedges	511	945
Leases, primarily due to differences in accounting for leases	373	334
Premises and equipment, primarily due to differences in original cost basis and depreciation	577	563
Other	296	—
Deferred tax liability	1,757	1,842
Valuation allowance	(227)	(249)
Net deferred tax asset	\$ 5,624	1,067

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The valuation allowance primarily represents the tax benefits of a certain state net operating loss carryforward which may expire without being utilized. During 2008, the valuation allowance decreased \$22,000 due to the expiration of a portion of these benefits. In assessing the realizability of deferred tax assets, management believes it is more likely than not that the deferred taxes will be realized.

The Company adopted FIN 48 on January 1, 2007. Although the implementation of FIN 48 did not result in a cumulative affect to retained earnings at the date of adoption, the Company did have an unrecognized tax benefit of approximately \$218,000 at January 1, 2007.

At December 31, 2008, the Company had an unrecognized tax benefit of \$131,000. If this benefit was recognized, it would affect the Company's effective tax rate. The Company recognizes interest as a component of tax expense. We had approximately \$18,000 of interest accrued at December 31, 2008 and no penalties. Interest included in tax expense for 2008 is approximately \$2,000.

A reconciliation of unrecognized tax benefits at December 31 is as follows (in thousands):

	<u>2008</u>	<u>2007</u>
Balance at January 1	\$ 156	218
Change in unrecognized tax benefits in the current year	<u>(25)</u>	<u>(62)</u>
Balance at December 31	<u>\$ 131</u>	<u>156</u>

The Company files consolidated federal and unitary state income tax returns where allowed. Tax years ended December 31, 2005 through 2007 remain open to federal examination, although there are no examinations in progress at this time. Tax years ended December 31, 2004 through 2007 remain open to state examinations.

It is reasonably possible the unrecognized tax benefit discussed above may be reduced by \$39,000 within the next twelve months. This amount includes \$8,000 of interest and no penalties.

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(25) Earnings per Share

The following table shows the amounts used in computing EPS and the effect of weighted average number of shares of potential dilutive common stock issuances. Net income (loss) per share was calculated as follows:

	2008	2007
Denominator for basic earnings per share:		
Average common shares outstanding	\$ 3,291,697	3,456,993
Dilutive common stock options	27,528	58,859
Denominator for diluted earnings per share	\$ 3,319,225	3,515,852
Numerator:		
Net income (loss) attributable to continuing operations	\$ 2,218	(3,069)
Net income attributable to discontinued operations	—	5,049
Net income attributable to common shareholders	\$ 2,218	1,980
Net income per share:		
Basic earnings (loss) per share from continuing operations	\$ 0.67	(0.89)
Basic earnings per share from discontinued operations	—	1.46
Basic earnings per common share	0.67	0.57
Diluted earnings (loss) per share from continuing operations	\$ 0.67	(0.89)
Diluted earnings per share from discontinued operations	—	1.46
Diluted earnings per common share	0.67	0.57

Pursuant to SFAS No. 128, *Earnings per Share*, no contingent shares are included in the computation of the diluted per share amounts because a loss exists in continuing operations in 2007.

At December 31, 2008 and 2007, options totaling 12,200 and 54,000, respectively, were outstanding but not included in the computation of diluted EPS because their exercise prices were higher than the average price of the Company's common stock. Exercise prices ranged from \$7.00 to \$8.75.

(26) Benefit Plans

BNCCORP has a qualified, tax-exempt 401(k) savings plan covering all employees of BNCCORP and its subsidiaries who meet specified age and service requirements. Under the plan, eligible employees may elect to defer up to 50% of compensation each year not to exceed the dollar limit set by law. At their discretion, BNCCORP and its subsidiaries may provide matching contributions to the plan. In 2008 and 2007, BNCCORP and its subsidiaries made matching contributions of up to 50% of employee deferrals up to a maximum employer contribution of 5% of employee compensation. Generally, all participant contributions and earnings are fully and immediately vested. The Company makes its matching contribution during the first calendar quarter following the last day of each calendar year and an employee must be employed by the Company on the last day of the calendar year in order to receive the current year's employer match. The anticipated matching contribution is expensed monthly over the course of the

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calendar year based on employee contributions made throughout the year. The Company made matching contributions of \$387,000 and \$378,000 for 2008 and 2007, respectively. Under the investment options available under the 401(k) savings plan, prior to January 28, 2008, employees could elect to invest their salary deferrals in BNCCORP common stock. At December 31, 2008, the assets in the plan totaled \$11.5 million and included \$938,000 (138,805 shares) invested in BNCCORP common stock. On January 28, 2008, the Company voluntarily delisted from the NASDAQ Global Market and deregistered its common stock under the Securities Exchange Act of 1934 (as amended). As a result, the participants are prohibited from making new investments of the Company's common stock in the plan.

(27) Commitments and Contingencies

Employment Agreements and Noncompete Covenants

The Company has entered into an employment agreement with its President and Chief Executive Officer (the President). The President will be paid a minimum annual salary throughout the term of the agreement and annual incentive bonuses as may, from time to time, be determined by the Board. The President will also be provided with benefits under any employee benefit plan maintained by BNCCORP for its employees generally, or for its senior executive officers in particular, on the same terms as are applicable to other senior executives of BNCCORP. Under the agreement, if the President's status as an employee with the Company is terminated for any reason other than death, disability, cause, as defined in the agreement, or if he terminates his employment for good reason, as defined in the agreement, or following a change in control of BNCCORP, as defined in the agreement, then the President will be paid a lump-sum amount equal to three times his current annual compensation.

In December 2007, the Chairman of the Board announced his retirement. The former Chairman received an award of \$1.160 million upon retirement from the Company which was reflected in accrued expenses on the consolidated balance sheet as of December 31, 2007.

Leases

The Bank has entered into operating lease agreements for certain facilities and equipment used in its operations. Rent expense for the years ended December 31, 2008 and 2007 was \$1.063 million and \$830,000, respectively, for facilities, and \$39,000 and \$51,000, respectively, for equipment and other items. At December 31, 2008, the total minimum annual base lease payments for operating leases were as follows (in thousands):

2009	\$	1,256
2010		1,138
2011		866
2012		621
2013		121
Thereafter		1,560

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(28) Share-Based Compensation

The Company has three 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. Under the 1995 Stock Incentive Plan, the aggregate number of options and shares granted can not exceed 250,000 shares. Under the 2002 Stock Incentive Plan, the aggregate number of shares can not exceed 125,000 shares. Under the 2006 Stock Incentive Plan, the aggregate number of shares can not exceed 200,000 shares. Pursuant to each plan, the compensation committee may grant options at prices equal to the fair value of the stock at the grant date.

Total shares available and maximum restricted shares available as of December 31, 2008 are as follows:

	1995 Stock Incentive Plan	2002 Stock Incentive Plan	2006 Stock Incentive Plan	Total
Total shares available	58,751	107,250	136,600	302,601
Maximum restricted shares available	58,751	7,250	136,600	202,601

The Company recognized share-based compensation expense of \$342,000 and \$312,000 for the twelve months ended December 31, 2008 and 2007, respectively all of which related to restricted stock.

At December 31, 2008, the Company had \$352,000 of unamortized restricted stock compensation. At December 31, 2007, the Company had \$552,000 of unamortized restricted stock compensation. Restricted shares of stock granted generally have vesting and amortization periods of at least three years.

Following is a summary of restricted stock transactions for the years ended December 31:

	2008		2007	
	Number restricted stock shares	Weighted average grant date fair value	Number restricted stock shares	Weighted average grant date fair value
Nonvested, beginning of year	51,766	\$ 12.50	100,500	\$ 13.07
Granted	19,500	11.03	—	—
Vested	(26,434)	12.46	(34,734)	13.15
Forfeited	(7,500)	9.60	(14,000)	15.05
Nonvested, end of year	<u>37,332</u>		<u>51,766</u>	

No stock options were granted during 2008 or 2007 and the Company had no unrecognized share-based compensation expense related to stock options during these periods.

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Following is a summary of stock option transactions for the years ended December 31:

	2008		2007	
	Options to purchase shares	Weighted average exercise price	Options to purchase shares	Weighted average exercise price
Outstanding, beginning of year	107,700	\$ 11.76	115,000	\$ 11.49
Granted	—	—	—	—
Exercised	(8,000)	5.94	(6,000)	6.15
Forfeited	(55,500)	17.04	(1,300)	17.00
Outstanding, end of year	<u>44,200</u>	6.34	<u>107,700</u>	11.76
Exercisable, end of year	<u>44,200</u>	6.34	<u>107,700</u>	11.76
Weighted average fair value of options:				
Granted	\$ —		\$ —	
Exercised	2.80		2.99	
Forfeited	7.53		7.60	

Following is a summary of the status of options outstanding at December 31, 2008:

	Outstanding options			Exercisable options	
	Number	Weighted average remaining contractual life	Weighted average exercise price	Number	Weighted average exercise price
Options with exercise prices ranging from:					
\$5.94 to \$8.75	<u>44,200</u>	2.3 years	\$ 6.34	<u>44,200</u>	\$ 6.34
	<u>44,200</u>			<u>44,200</u>	

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(29) Condensed Financial Information – Parent Company Only

Condensed financial information of BNCCORP on a parent company only basis is as follows:

Parent Company Only

Condensed Balance Sheets

(In thousands, except per share data)

	<u>2008</u>	<u>2007</u>
Assets:		
Cash and cash equivalents	\$ 1,766	954
Investment in subsidiaries	76,526	83,254
Receivable from subsidiaries	570	545
Deferred charges and intangible assets, net	154	154
Other	446	525
	<u>79,462</u>	<u>85,432</u>
Total assets	\$ <u>79,462</u>	<u>85,432</u>
Liabilities and stockholders' equity:		
Subordinated debentures	\$ 23,115	23,112
Payable to subsidiaries	487	100
Accrued expenses and other liabilities	1,913	2,490
	<u>25,515</u>	<u>25,702</u>
Total liabilities	<u>25,515</u>	<u>25,702</u>
Preferred stock, \$0.01 par value – 2,000,000 shares authorized; no shares issued or outstanding	—	—
Common stock, \$0.01 par value – 10,000,000 shares authorized; 3,299,163 and 3,491,337 shares issued and outstanding	33	35
Capital surplus – common stock	26,628	26,355
Retained earnings	36,104	34,105
Treasury stock (357,738 and 150,116 shares)	(5,020)	(2,424)
Accumulated other comprehensive income (loss), net of income taxes	(3,798)	1,659
	<u>53,947</u>	<u>59,730</u>
Total stockholders' equity	<u>53,947</u>	<u>59,730</u>
Total liabilities and stockholders' equity	\$ <u>79,462</u>	<u>85,432</u>

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Parent Company Only

Condensed Statements of Income

(In thousands)

	<u>2008</u>	<u>2007</u>
Income:		
Management fee income	\$ 1,599	1,730
Interest	17	40
Other	76	65
Total income	<u>1,692</u>	<u>1,835</u>
Expenses:		
Interest	1,728	2,212
Salaries and benefits	829	2,392
Legal and other professional	443	635
Depreciation and amortization	3	4
Other	610	1,924
Total expenses	<u>3,613</u>	<u>7,167</u>
Loss before income tax benefit and equity in income of subsidiaries	(1,921)	(5,332)
Income tax benefit	<u>646</u>	<u>2,078</u>
Loss before equity in income of subsidiaries	(1,275)	(3,254)
Equity in income of subsidiaries	<u>3,493</u>	<u>5,234</u>
Net income	<u>\$ 2,218</u>	<u>1,980</u>

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Parent Company Only

Condensed Statements of Cash Flows

(In thousands)

	<u>2008</u>	<u>2007</u>
Operating activities:		
Net income	\$ 2,218	1,980
Adjustments to reconcile net income to net cash used in operating activities:		
Equity in income of subsidiaries	(3,493)	(5,234)
Depreciation and amortization	6	340
Deferred income taxes	110	(395)
Change in prepaid expenses and other receivables	(61)	37
Change in accrued expenses and other liabilities	(408)	1,255
Net cash used in operating activities	<u>(1,628)</u>	<u>(2,017)</u>
Investing activities:		
Increase in investment in subsidiaries	4,765	4,675
Net cash provided by investing activities	<u>4,765</u>	<u>4,675</u>
Financing activities:		
Repayments of long-term borrowings	—	(1,167)
Proceeds from issuance of share-based compensation	273	298
Purchase of treasury stock	(2,598)	(1,720)
Net cash used in financing activities	<u>(2,325)</u>	<u>(2,589)</u>
Net increase in cash and cash equivalents	812	69
Cash and cash equivalents, beginning of year	954	885
Cash and cash equivalents, end of year	<u>\$ 1,766</u>	<u>954</u>
Supplemental cash flow information:		
Interest paid	\$ 1,675	2,314
Income tax payments received from the subsidiary bank, net of income taxes paid	2,173	3,322