



# BNCCORP

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## **Quarterly Report**

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**For the quarter ended June 30, 2008**

**BNCCORP, INC.**

**(Pink Sheets:BNCC)**

322 East Main  
Bismarck, North Dakota 58501  
(701) 250-3040

**BNCCORP, INC.**  
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**June 30, 2008**

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# FINANCIAL INFORMATION

## Item 1. Financial Statements

### BNCCORP, INC. AND SUBSIDIARIES

#### Consolidated Balance Sheets

(In thousands, except share data)

| ASSETS   | June 30,<br>2008  | December 31,<br>2007 |
|--|-------------------|----------------------|
|  | (unaudited)       |                      |
| CASH AND CASH EQUIVALENTS  | \$ 15,899         | \$ 14,856            |
| INVESTMENT SECURITIES AVAILABLE FOR SALE   | 200,312           | 122,899              |
| FEDERAL RESERVE BANK AND FEDERAL HOME LOAN BANK STOCK  | 7,077             | 4,918                |
| LOANS HELD FOR SALE  | 5,758             | -                    |
| PARTICIPATING INTERESTS IN MORTGAGE LOANS  | 25,333            | 24,357               |
| LOANS AND LEASES HELD FOR INVESTMENT   | 525,875           | 497,556              |
| ALLOWANCE FOR CREDIT LOSSES  | (7,065)           | (6,599)              |
| Net loans and leases   | 544,143           | 515,314              |
| OTHER REAL ESTATE  | 5,098             | -                    |
| PREMISES AND EQUIPMENT, net  | 20,674            | 19,448               |
| INTEREST RECEIVABLE  | 3,255             | 3,290                |
| OTHER ASSETS   | 19,505            | 15,294               |
| PREMISES AND EQUIPMENT HELD FOR SALE, net  | -                 | 3,572                |
|  | <u>\$ 821,721</u> | <u>\$ 699,591</u>    |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                   |                      |
| DEPOSITS:  |                   |                      |
| Non-interest-bearing   | \$ 64,832         | \$ 72,234            |
| Interest-bearing –   |                   |                      |
| Savings, interest checking and money market  | 271,844           | 245,722              |
| Time deposits \$100,000 and over   | 114,550           | 44,038               |
| Other time deposits  | 174,113           | 179,880              |
| Total deposits   | 625,339           | 541,874              |
| SHORT-TERM BORROWINGS  | 6,206             | 5,365                |
| FEDERAL HOME LOAN BANK ADVANCES  | 102,000           | 61,400               |
| LONG-TERM BORROWINGS   | -                 | -                    |
| GUARANTEED PREFERRED BENEFICIAL INTERESTS IN COMPANY'S<br>SUBORDINATED DEBENTURES                                      | 22,974            | 23,075               |
| ACCRUED INTEREST PAYABLE   | 2,992             | 2,843                |
| ACCRUED EXPENSES   | 3,136             | 3,387                |
| OTHER LIABILITIES  | 2,133             | 1,917                |
| Total Liabilities  | 764,780           | 639,861              |
| STOCKHOLDERS' EQUITY:  |                   |                      |
| Common stock, \$.01 par value – 10,000,000 shares authorized; 3,301,211 and 3,491,337<br>shares issued and outstanding | 35                | 35                   |
| Capital surplus – common stock   | 26,520            | 26,355               |
| Retained earnings  | 35,950            | 34,105               |
| Treasury stock (350,442 and 150,116 shares)  | (5,005)           | (2,424)              |
| Accumulated other comprehensive income (loss), net   | (559)             | 1,659                |
| Total stockholders' equity   | <u>56,941</u>     | <u>59,730</u>        |
|  | <u>\$ 821,721</u> | <u>\$ 699,591</u>    |

See accompanying notes to consolidated financial statements.

**BNCCORP, INC. AND SUBSIDIARIES**

Consolidated Statements of Income

(In thousands, except per share data, unaudited)

|   | For the Three Months |                | For the Six Months |                |
|---|----------------------|----------------|--------------------|----------------|
|   | Ended June 30,       |                | Ended June 30,     |                |
|   | 2008                 | 2007           | 2008               | 2007           |
| <b>INTEREST INCOME:</b>                                       |                      |                |                    |                |
| Interest and fees on loans                                    | \$ 8,861             | \$ 9,070       | \$ 18,374          | \$ 17,406      |
| Interest and dividends on investments -                       |                      |                |                    |                |
| Taxable   | 2,331                | 1,749          | 3,899              | 4,000          |
| Tax-exempt  | 233                  | 231            | 466                | 462            |
| Dividends   | 71                   | 83             | 142                | 141            |
| Total interest income   | <u>11,496</u>        | <u>11,133</u>  | <u>22,881</u>      | <u>22,009</u>  |
| <b>INTEREST EXPENSE:</b>                                      |                      |                |                    |                |
| Deposits  | 3,758                | 4,403          | 7,746              | 8,860          |
| Short-term borrowings   | 28                   | 109            | 69                 | 219            |
| Federal Home Loan Bank advances                               | 549                  | 691            | 1,168              | 1,627          |
| Long-term borrowings  | 15                   | 1              | 23                 | 9              |
| Subordinated debentures                                       | 381                  | 569            | 838                | 1,135          |
| Total interest expense  | <u>4,731</u>         | <u>5,773</u>   | <u>9,844</u>       | <u>11,850</u>  |
| Net interest income   | <u>6,765</u>         | <u>5,360</u>   | <u>13,037</u>      | <u>10,159</u>  |
| PROVISION FOR CREDIT LOSSES                                   | 2,000                | 700            | 2,800              | 950            |
| NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES         | <u>4,765</u>         | <u>4,660</u>   | <u>10,237</u>      | <u>9,209</u>   |
| <b>NON-INTEREST INCOME (LOSS):</b>                            |                      |                |                    |                |
| Bank charges and service fees                                 | 518                  | 558            | 1,009              | 1,099          |
| Wealth management revenues                                    | 768                  | 346            | 1,524              | 802            |
| Mortgage banking revenues                                     | 776                  | 74             | 750                | 115            |
| Gains on sales of loans                                       | 253                  | 614            | 1,039              | 936            |
| Gain on sales of premises and equipment                       | 794                  | -              | 794                | -              |
| Net losses on sales of securities                             | -                    | (2,026)        | -                  | (2,026)        |
| Other   | 249                  | 150            | 542                | 487            |
| Total non-interest income (loss)                              | <u>3,358</u>         | <u>(284)</u>   | <u>5,658</u>       | <u>1,413</u>   |
| <b>NON-INTEREST EXPENSE:</b>                                  |                      |                |                    |                |
| Salaries and employee benefits                                | 3,938                | 3,674          | 7,361              | 7,114          |
| Occupancy   | 547                  | 537            | 989                | 1,074          |
| Data processing fees  | 522                  | 565            | 931                | 1,166          |
| ORE expenses  | 402                  | -              | 402                | -              |
| Depreciation and amortization                                 | 327                  | 429            | 669                | 890            |
| Professional services   | 294                  | 226            | 482                | 380            |
| Marketing and promotion                                       | 267                  | 159            | 462                | 349            |
| Office supplies, telephone and postage                        | 169                  | 122            | 376                | 253            |
| FDIC and other assessments                                    | 56                   | 59             | 110                | 116            |
| Prepayment penalties on early extinguishment of FHLB advances | -                    | 1,535          | -                  | 1,535          |
| Other   | 556                  | 433            | 1,035              | 848            |
| Total non-interest expense                                    | <u>7,078</u>         | <u>7,739</u>   | <u>12,817</u>      | <u>13,725</u>  |
| Income (loss) from continuing operations before income taxes  | 1,045                | (3,363)        | 3,078              | (3,103)        |
| Income tax provision (benefit)                                | 345                  | (1,386)        | 1,016              | (1,387)        |
| Income (loss) from continuing operations                      | <u>700</u>           | <u>(1,977)</u> | <u>2,062</u>       | <u>(1,716)</u> |

See accompanying notes to consolidated financial statements.

**BNCCORP, INC. AND SUBSIDIARIES**  
Consolidated Statements of Income, continued  
(In thousands, except per share data, unaudited)

|   | <b>For the Three Months</b> |                 | <b>For the Six Months</b> |                 |
|---|-----------------------------|-----------------|---------------------------|-----------------|
|   | <b>Ended June 30,</b>       |                 | <b>Ended June 30,</b>     |                 |
|   | <b>2008</b>                 | <b>2007</b>     | <b>2008</b>               | <b>2007</b>     |
| <b>Discontinued Operations:</b>                                 |                             |                 |                           |                 |
| Income from discontinued insurance segment                      | \$ -                        | \$ 6,084        | \$ -                      | \$ 8,154        |
| Income tax provision  | -                           | 2,280           | -                         | 3,054           |
| Income from discontinued operations                             | -                           | 3,804           | -                         | 5,100           |
| <b>NET INCOME</b>   | <b>\$ 700</b>               | <b>\$ 1,827</b> | <b>\$ 2,062</b>           | <b>\$ 3,384</b> |
| <b>BASIC EARNINGS PER COMMON SHARE:</b>                         |                             |                 |                           |                 |
| Income (loss) from continuing operations                        | \$ 0.22                     | \$ (0.56)       | \$ 0.62                   | \$ (0.49)       |
| Income from discontinued insurance segment, net of income taxes | -                           | 1.08            | -                         | 1.45            |
| <b>Basic earnings per common share</b>                          | <b>\$ 0.22</b>              | <b>\$ 0.52</b>  | <b>\$ 0.62</b>            | <b>\$ 0.96</b>  |
| <b>DILUTED EARNINGS PER COMMON SHARE</b>                        |                             |                 |                           |                 |
| Income (loss) from continuing operations                        | \$ 0.21                     | \$ (0.56)       | \$ 0.61                   | \$ (0.49)       |
| Income from discontinued insurance segment, net of income taxes | -                           | 1.08            | -                         | 1.45            |
| <b>Diluted earnings per common share</b>                        | <b>\$ 0.21</b>              | <b>\$ 0.52</b>  | <b>\$ 0.61</b>            | <b>\$ 0.96</b>  |

See accompanying notes to consolidated financial statements.

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

|   | <u>Common Stock</u> |               | <b>Capital<br/>Surplus</b> | <b>Retained<br/>Earnings</b> | <b>Treasury<br/>Stock</b> | <b>Accumulated<br/>Other<br/>Comprehensive<br/>Income</b> | <b>Total</b>     |
|---|---------------------|---------------|----------------------------|------------------------------|---------------------------|---|------------------|
|   | <u>Shares</u>       | <u>Amount</u> | <u>Common<br/>Stock</u>    |                              |                           |   |                  |
|   |                     |               |                            |                              |                           |   |                  |
| BALANCE, December 31, 2006  | 3,600,467           | \$ 36         | \$ 25,950                  | \$ 32,125                    | \$ (598)                  | \$ (1,911)  | \$ 55,602        |
| Net income  | -                   | -             | -                          | 3,384                        | -                         | -   | 3,384            |
| Other comprehensive gain  | -                   | -             | -                          | -                            | -                         | 1,002   | 1,002            |
| Impact of share-based compensation  | (12,900)            | -             | 96                         | -                            | -                         | -   | 96               |
| Issuance of common shares   | -                   | -             | -                          | -                            | -                         | -   | -                |
| <b>BALANCE, June 30, 2007</b>   | <b>3,587,567</b>    | <b>\$ 36</b>  | <b>\$ 26,046</b>           | <b>\$ 35,509</b>             | <b>\$ (598)</b>           | <b>\$ (909)</b>   | <b>\$ 60,084</b> |
| BALANCE, December 31, 2007  | 3,491,337           | \$ 35         | \$ 26,355                  | \$ 34,105                    | \$ (2,424)                | \$ 1,659  | \$ 59,730        |
| Net income  | -                   | -             | -                          | 2,062                        | -                         | -   | 2,062            |
| Other comprehensive loss  | -                   | -             | -                          | -                            | -                         | (2,218)   | (2,218)          |
| Cumulative effect of change in accounting principle related to split dollar life insurance policies | -                   | -             | -                          | (217)                        | -                         | -   | (217)            |
| Impact of share-based compensation  | 10,200              | -             | 165                        | -                            | -                         | -   | 165              |
| Purchase of common shares   | (200,326)           | -             | -                          | -                            | (2,581)                   | -   | (2,581)          |
| <b>BALANCE, June 30, 2008</b>   | <b>3,301,211</b>    | <b>\$ 35</b>  | <b>\$ 26,520</b>           | <b>\$ 35,950</b>             | <b>\$ (5,005)</b>         | <b>\$ (559)</b>   | <b>\$ 56,941</b> |

See accompanying notes to consolidated financial statements.

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

|  | <b>For the Three Months<br/>Ended June 30,</b> |                |                 |            | <b>For the Six Months<br/>Ended June 30,</b> |                |                 |              |
|--|--|----------------|-----------------|------------|--|----------------|-----------------|--------------|
|  | <b>2008</b>                                    |                | <b>2007</b>     |            | <b>2008</b>                                  |                | <b>2007</b>     |              |
| NET INCOME   | \$ 700   |                | \$ 1,827        |            | \$ 2,062                                     |                | \$ 3,384        |              |
| Unrealized gain (loss) on cash flow hedge, net                                     | \$ (650)                                       |                | \$ (104)        |            | \$ 374                                       |                | \$ (64)         |              |
| Unrealized loss on securities available for sale                                   | (2,530)  |                | (1,269)         |            | (4,006)                                      |                | (376)           |              |
| Reclassification adjustment for gain included in net income                        | -  |                | 2,026           |            | -  |                | 2,026           |              |
| Other comprehensive income (loss), before tax                                      | (3,180)  |                | 653             |            | (3,632)                                      |                | 1,586           |              |
| Income tax (expense) benefit related to items of other comprehensive income (loss) | 1,273  |                | (238)           |            | 1,414  |                | (584)           |              |
| Other comprehensive income (loss)  | <u>(1,907)</u>                                 | <u>(1,907)</u> | <u>415</u>      | <u>415</u> | <u>(2,218)</u>                               | <u>(2,218)</u> | <u>1,002</u>    | <u>1,002</u> |
| TOTAL COMPREHENSIVE INCOME (LOSS)  | <u>\$ (1,207)</u>                              |                | <u>\$ 2,242</u> |            | <u>\$ (155)</u>                              |                | <u>\$ 4,386</u> |              |

See accompanying notes to consolidated financial statements.

**BNCCORP, INC. AND SUBSIDIARIES**

Consolidated Statements of Cash Flows

For the Six Months Ended June 30,

(In thousands, unaudited)

|  | <u>2008</u>      | <u>2007</u>      |
|--|------------------|------------------|
| <b>OPERATING ACTIVITIES:</b>   |                  |                  |
| Net income   | \$ 2,062         | \$ 3,384         |
| Adjustments to reconcile net income to net cash provided by operating activities |                  |                  |
| Provision for credit losses  | 2,800            | 950              |
| Depreciation and amortization  | 670              | 834              |
| Amortization of intangible assets and deferred charges                           | -                | 64               |
| Share-based compensation   | 165              | 84               |
| Net amortization of premiums and discounts                                       | (611)            | 371              |
| Charge-off of loans net of recoveries  | (2,334)          | 14               |
| Change in interest receivable and other assets, net                              | (3,742)          | (2,008)          |
| (Gain) loss on disposals of premises and equipment, net                          | (794)            | 56               |
| Net realized loss on sales of investment securities                              | -                | 2,026            |
| Provision for deferred income taxes  | (153)            | (425)            |
| Change in other liabilities, net   | 1,301            | 25,281           |
| Originations of loans to be participated   | (123,457)        | (121,359)        |
| Proceeds from participations of loans  | 123,457          | 121,359          |
| Funding of originations of loans held for sale                                   | (37,068)         | (7,650)          |
| Proceeds from sale of loans held for sale  | 31,438           | 9,078            |
| Fair value adjustment for loans held for sale                                    | (127)            | -                |
| Change in operating accounts of discontinued operations                          | -                | (2,785)          |
| Gain on sale of discontinued operations  | -                | (6,083)          |
| Net cash (used) provided by operating activities                                 | <u>(6,393)</u>   | <u>23,191</u>    |
| <b>INVESTING ACTIVITIES:</b>   |                  |                  |
| Change in Federal funds sold, net  | -                | 1,500            |
| Purchases of investment securities   | (95,732)         | -                |
| Proceeds from sales of investment securities                                     | -                | 59,453           |
| Proceeds from maturities of investment securities                                | 14,924           | 15,468           |
| Purchases of Federal Reserve and Federal Home Loan Bank Stock                    | (6,146)          | -                |
| Sales of Federal Reserve and Federal Home Loan Bank Stock                        | 3,987            | 2,768            |
| Net (increase) decrease in participating interests in mortgage loans             | (976)            | 37,942           |
| Net increase in loans held for investment  | (33,417)         | (90,067)         |
| Additions to premises and equipment  | (2,129)          | (460)            |
| Sales of premises and equipment  | 4,600            | 28               |
| Proceeds from sale of discontinued operations, net                               | -                | 35,204           |
| Net cash (used) provided by investing activities                                 | <u>(114,889)</u> | <u>61,836</u>    |
| <b>FINANCING ACTIVITIES:</b>   |                  |                  |
| Net increase (decrease) in deposits  | 83,465           | (25,864)         |
| Net increase (decrease) in short-term borrowings                                 | 841              | (2,781)          |
| Repayments of long-term borrowings and subordinated debentures                   | -                | (1,167)          |
| Proceeds from FHLB advances  | 1,918,515        | -                |
| Repayments of FHLB advances  | (1,877,915)      | (62,200)         |
| Purchase of treasury stock   | (2,581)          | -                |
| Net cash provided (used) by financing activities                                 | <u>122,325</u>   | <u>(92,012)</u>  |
| <b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>                      | <b>1,043</b>     | <b>(6,985)</b>   |
| <b>CASH AND CASH EQUIVALENTS, beginning of period</b>                            | <b>14,856</b>    | <b>18,216</b>    |
| <b>CASH AND CASH EQUIVALENTS, end of period</b>                                  | <b>\$ 15,899</b> | <b>\$ 11,231</b> |
| <b>SUPPLEMENTAL CASH FLOW INFORMATION:</b>                                       |                  |                  |
| Interest paid  | \$ 9,695         | \$ 12,856        |
| Income taxes paid  | \$ 1,812         | \$ 1,679         |

See accompanying notes to consolidated financial statements.

**BNCCORP, INC. AND SUBSIDIARIES**  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)  
June 30, 2008

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

BNCCORP, Inc. (“BNCCORP”) is a registered bank holding company incorporated under the laws of Delaware. It is the parent company of BNC National Bank (together with its wholly owned subsidiaries, BNC Insurance Services, Inc., and BNC Asset Management, Inc., collectively the “Bank”). The Company operates community banking, mortgage banking and wealth management businesses in Arizona, Minnesota and North Dakota from 20 locations. BNC also conducts mortgage banking from 4 locations in Iowa, Kansas and Missouri.

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

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

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

The unaudited consolidated financial statements as of June 30, 2008 include, in the opinion of management, all adjustments, consisting solely of normal recurring adjustments, necessary for a fair presentation of the financial results for the respective interim periods and are not necessarily indicative of results of operations to be expected for the entire fiscal year.

The accompanying interim consolidated financial statements have been prepared under the presumption that users of the interim consolidated financial information have either read or have access to the audited consolidated financial statements for the year ended December 31, 2007. Accordingly, footnote disclosures which would substantially duplicate the disclosures contained in the December 31, 2007 audited consolidated financial statements have been omitted from these interim consolidated financial statements. It is suggested that these interim consolidated financial statements be read in conjunction with the audited consolidated financial statements for the year ended December 31, 2007 and the notes thereto.

The Company’s critical accounting policies are unchanged since December 31, 2007.

**NOTE 3 – Reclassifications**

Certain of the 2007 amounts have been reclassified to conform to the 2008 presentations. These reclassifications had no effect on net income or stockholders’ equity.

**NOTE 4 – Recently Issued or Adopted Accounting Standards**

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 (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 \$217,000.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. This Statement defines fair value, establishes a framework for measuring fair value in 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 No. 157 on January 1, 2008 did not have a material impact on the Company's results of operations or financial position.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities, Including an amendment of FASB Statement No. 115*. 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 did not have a material impact on the Company's financial statements.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51*. This Statement amends ARB No. 51 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 is not anticipated to have a material 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 issued for fiscal years beginning after December 15, 2008, and for interim periods within those fiscal years. The impact of adopting this Statement on January 1, 2009 is not anticipated to have a material impact on the Company's results of operations or financial position.

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 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.

## **NOTE 5 – Divestiture and Discontinued Operations**

The Company reached an agreement to sell substantially all of the assets of the BNC Insurance Services Inc. (BNC Insurance) in March 2007. Stockholders approved the transaction in May 2007 and on June 1, 2007, the Company completed the sale. The proceeds from the sale were \$37.25 million and a pre-tax gain on sale of \$6.083 million was recognized in the second quarter of 2007.

BNC Insurance was previously reported as the insurance segment of the Company.

## NOTE 6 – Earnings Per Share

Net income (loss) per share was calculated as follows:

|   | <b>Three months ended<br/>June 30, 2008</b> | <b>Six months ended<br/>June 30, 2008</b> |
|---|---|---|
| Denominator for basic earnings per share:                     |   |   |
| Average common shares outstanding                             | 3,248,101                                   | 3,327,961                                 |
| Dilutive common stock options                                 | 46,458                                      | 44,059                                    |
| Denominator for diluted earnings per share                    | 3,294,559                                   | 3,372,020                                 |
|   |   |   |
| Numerator: Net gain attributable to continuing operations     | \$ 713                                      | \$ 2,102                                  |
| Numerator: Net gain attributable to discontinued operations   | -   | -   |
| Numerator: Net income   | \$ 700                                      | \$ 2,062                                  |
|   |   |   |
| Basic earnings per share from continuing operations           | \$ 0.22                                     | \$ 0.62                                   |
| Basic earnings per share from discontinued operations         | -   | -   |
| Basic earnings per common share                               | \$ 0.22                                     | \$ 0.62                                   |
| Diluted earnings per share from continuing operations         | \$ 0.21                                     | \$ 0.61                                   |
| Diluted earnings per share from discontinued operations       | -   | -   |
| Diluted earnings per common share                             | \$ 0.21                                     | \$ 0.61                                   |
|   |   |   |
|   | <b>Three months ended<br/>June 30, 2007</b> | <b>Six months ended<br/>June 30, 2007</b> |
| Denominator for basic earnings per share:                     |   |   |
| Average common shares outstanding                             | 3,501,544                                   | 3,501,280                                 |
| Dilutive common stock options*                                | 71,637                                      | 63,405                                    |
| Denominator for diluted earnings per share*                   | 3,573,181                                   | 3,564,685                                 |
|   |   |   |
| Numerator: Net (loss) attributable to continuing operations   | \$ (1,977)                                  | \$ (1,716)                                |
| Numerator: Net income attributable to discontinued operations | 3,804                                       | 5,100                                     |
| Numerator: Net income   | \$ 1,827                                    | \$ 3,384                                  |
|   |   |   |
| Basic (loss) per share from continuing operations             | \$ (0.56)                                   | \$ (0.49)                                 |
| Basic earnings per share from discontinued operations         | 1.08  | 1.45                                      |
| Basic earnings per common share                               | \$ 0.52                                     | \$ 0.96                                   |
| Diluted (loss) per share from continuing operations*          | \$ (0.56)                                   | \$ (0.49)                                 |
| Diluted earnings per share from discontinued operations*      | 1.08  | 1.45                                      |
| Diluted earnings per common share*                            | \$ 0.52                                     | \$ 0.96                                   |

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

For the three months ended June 30, 2008 and 2007, there were 2,600 options outstanding excluded from the computation of diluted EPS because their exercise prices were higher than the average price of BNCCORP's common stock for the period and are considered anti-dilutive. For the six months ended June 30, 2008 and 2007,

there were 2,600 options outstanding excluded from the computation of diluted EPS because their exercise prices were higher than the average price of BNCCORP's common stock for the period.

## NOTE 7 – Segment Disclosures

The Company significantly expanded its mortgage banking capacity by acquiring certain assets and assuming certain liabilities in the second quarter of 2008 and concurrently changed its reportable segments. Segment disclosures have been restated for all periods. Continuing operations has three segments based on the nature of the products and services for each segment: banking operations, mortgage banking and wealth management services. Prior to the second quarter of 2007, the Company had three segments. Beginning in the second quarter of 2007, the insurance operations were no longer reported as a segment as they are included in discontinued operations.

Banking operations provide traditional banking services to small and mid-sized businesses and individuals, such as accepting deposits and making loans. The commercial banking activities also include the origination of loans which may be sold and serviced for other institutions.

Mortgage banking operations originate loans and sell loans, servicing released, to investors. The majority of loans originated by this segment are guaranteed by the FHA.

Wealth management operations provide a variety of financial services including trust, asset management, financial planning, estate planning, estate administration, tax planning, payroll services, employee benefit plan design and administration. We also offer retirement accounts and prepare tax returns.

The accounting policies of the segments are the same as those described in the summary of significant accounting policies included in Note 1 to the consolidated financial statements for the year ended December 31, 2007.

The Company's financial information for each segment is derived from the internal profitability reporting system used by management to monitor and manage the financial performance of the Company. The operating segments have been determined by how executive management has organized the Company's business for making operating decisions and assessing performance.

The following tables present segment information as of, and for the three months and the six months ended June 30, 2008, unaudited (in thousands):

|   | Three months ended June 30, 2008 |                     |                |                     |          |                             |                       |
|---|----------------------------------|---------------------|----------------|---------------------|----------|-----------------------------|-----------------------|
|   | Banking                          | Mortgage<br>Banking | Wealth<br>Mgmt | Bank<br>Holding Co. | Totals   | Intersegment<br>Elimination | Consolidated<br>Total |
| Net interest income (loss)                      | \$ 6,879                         | \$ 290              | \$ (14)        | \$ (402)            | \$ 6,753 | \$ 12                       | \$ 6,765              |
| Other revenue (loss)-<br>external customers     | 1,811                            | 782                 | 803            | 14                  | 3,410    | (52)                        | 3,358                 |
| Net income (loss) from<br>continuing operations | 969                              | 194                 | (46)           | (417)               | 700      | -                           | 700                   |
| Segment assets from<br>continuing operations    | 743,379                          | 33,823              | 44,723         | 83,099              | 905,024  | (83,303)                    | 821,721               |

**Six months ended June 30, 2008**

|   | Mortgage  |         | Wealth  | Bank        | Totals    | Intersegment | Consolidated |
|---|-----------|---------|---------|-------------|-----------|--------------|--------------|
|   | Banking   | Banking | Mgmt    | Holding Co. |           | Elimination  | Total        |
| Net interest income (loss)                      | \$ 13,393 | \$ 528  | \$ (34) | \$ (876)    | \$ 13,011 | \$ 26        | \$ 13,037    |
| Other revenue (loss)-<br>external customers     | 3,349     | 762     | 1,598   | 51          | 5,760     | (102)        | 5,658        |
| Net income (loss) from<br>continuing operations | 2,691     | 226     | (115)   | (740)       | 2,062     | -            | 2,062        |
| Segment assets from<br>continuing operations    | 743,379   | 33,823  | 44,723  | 83,099      | 905,024   | (83,303)     | 821,721      |

The following tables present segment information as of, and for the three months and the six months ended June 30, 2007, unaudited (in thousands):

**Three months ended June 30, 2007**

|   | Mortgage |         | Wealth | Bank        | Totals   | Intersegment | Consolidated |
|---|----------|---------|--------|-------------|----------|--------------|--------------|
|   | Banking  | Banking | Mgmt   | Holding Co. |          | Elimination  | Total        |
| Net interest income (loss)                      | \$ 5,568 | \$ 309  | \$ 47  | \$ (582)    | \$ 5,342 | \$ 18        | \$ 5,360     |
| Other revenue (loss)-<br>external customers     | (721)    | 96      | 385    | 18          | (222)    | (62)         | (284)        |
| Net income (loss) from<br>continuing operations | (1,388)  | 171     | (186)  | (502)       | (1,905)  | (72)         | (1,977)      |
| Segment assets from<br>continuing operations    | 575,642  | 23,353  | 25,852 | 88,622      | 713,469  | (89,719)     | 623,750      |

**Six months ended June 30, 2007**

|   | Mortgage  |         | Wealth | Bank        | Totals    | Intersegment | Consolidated |
|---|-----------|---------|--------|-------------|-----------|--------------|--------------|
|   | Banking   | Banking | Mgmt   | Holding Co. |           | Elimination  | Total        |
| Net interest income (loss)                      | \$ 10,499 | \$ 695  | \$ 97  | \$ (1,167)  | \$ 10,124 | \$ 35        | \$ 10,159    |
| Other revenue (loss)-<br>external customers     | 449       | 172     | 881    | 35          | 1,537     | (124)        | 1,413        |
| Net income (loss) from<br>continuing operations | (732)     | 374     | (329)  | (971)       | (1,658)   | (58)         | (1,716)      |
| Segment assets from<br>continuing operations    | 575,642   | 23,353  | 25,852 | 88,622      | 713,469   | (89,719)     | 623,750      |

## **NOTE 8 – 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. As of June 30, 2008, there were 54,751 shares available to grant under the 1995 Stock Incentive Plan. Under the 2002 Stock Incentive Plan, the aggregate number of shares granted can not exceed 125,000 shares. As of June 30, 2008, there were 107,250 shares available to grant under the 2002 Stock Incentive Plan. Under the 2006 Stock Incentive Plan, the aggregate number of shares granted can not exceed 200,000 shares. As of June 30, 2008, there were 136,600 shares available to grant under the 2006 Stock Incentive Plan. The Company may grant share-based compensation at prices equal to the fair value of the stock at the grant date.

There were no grants of stock options in 2008 or 2007. The cost of options previously granted, were fully amortized prior to 2007. A restricted stock grant of 10,000 shares under the 1995 Stock Incentive Plan was made in the second quarter of 2008.

The Company recognized share-based compensation expense of \$84,000 related to restricted stock for the three month period ended June 30, 2008 and \$165,000 for the six month period ended June 30, 2008. The Company recognized share-based compensation expense of \$57,000 related to restricted stock for the three months ended June 30, 2007 and \$84,000 for the six month period ended June 30, 2007.

At June 30, 2008, the Company had \$508,000 of unamortized restricted stock compensation expense. The majority of the unamortized restricted stock compensation expense as of June 30, 2008 will be amortized by December 31, 2012. The cost of restricted stock granted is recognized over the vesting period; which is generally three years.

## **NOTE 9 – Derivative Activities**

Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS 133), as amended and interpreted, establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. As required by SFAS 133, the Company records all derivatives on the balance sheet 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.

The Company's objective in using derivatives is to add stability to interest income and to manage its exposure to interest rate movements or other identified risks. To accomplish this objective, the Company entered into an interest rate floor agreement to hedge the variable cash flows associated with \$50.0 million of the Company's variable-rate loans. The floor was initiated January 9, 2006 and has 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 7.00%. At June 30, 2008, the prime rate was 5.00% and the Company is entitled to receive monthly payments under the terms of the agreement. The Company received payments totaling \$228,000 for the three months ended June 30, 2008 and \$283,000 for the six months ended June 30, 2008. The Company received no payments during the three and six months ended June 30, 2007.

At June 30, 2008, the fair value of the floor was \$1.1 million, which was included in other assets. The change in net unrealized losses of \$650,000 during the three months ended June 30, 2008 and the change in net unrealized gains of \$374,000 for the six months ended June 30, 2008 for derivatives designated as cash flow hedges is separately disclosed in the statement of comprehensive income. No hedge ineffectiveness on cash flow hedges was recognized during the quarter.

## **NOTE 10 – 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 June 30, 2008 or December 31, 2007. The carrying amount of available-for-sale securities and their approximate fair values were as follows (in thousands):

| <b>As of June 30, 2008</b>   | <b>Amortized<br/>Cost</b> | <b>Gross<br/>Unrealized<br/>Gains</b> | <b>Gross<br/>Unrealized<br/>Losses</b> | <b>Estimated<br/>Fair<br/>Value</b> |
|--|---------------------------|---------------------------------------|--|-------------------------------------|
| U.S. government agency mortgage-backed securities guaranteed by GNMA | \$ 1,658                  | \$ 2                                  | \$ (15)                                | \$ 1,645                            |
| U.S. government agency mortgage-backed securities issued by FNMA     | 3,003                     | 29                                    | (34)                                   | 2,998                               |
| Collateralized mortgage obligations guaranteed by GNMA               | 2,057                     | 24                                    | -                                      | 2,081                               |
| Collateralized mortgage obligations issued by FNMA or FHLMC          | 54,061                    | 897                                   | -                                      | 54,958                              |
| Other collateralized mortgage obligations                            | 123,294                   | 78                                    | (3,574)                                | 119,798                             |
| State and municipal bonds  | 17,967                    | 865                                   | -                                      | 18,832                              |
|  | <u>\$ 202,040</u>         | <u>\$ 1,895</u>                       | <u>\$ (3,623)</u>                      | <u>\$ 200,312</u>                   |

| <b>As of December 31, 2007</b>                                       | <b>Amortized<br/>Cost</b> | <b>Gross<br/>Unrealized<br/>Gains</b> | <b>Gross<br/>Unrealized<br/>Losses</b> | <b>Estimated<br/>Fair<br/>Value</b> |
|--|---------------------------|---------------------------------------|--|-------------------------------------|
| 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                              |
|  | <u>\$ 120,621</u>         | <u>\$ 2,397</u>                       | <u>\$ (119)</u>                        | <u>\$ 122,899</u>                   |

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 June 30, 2008 and December 31, 2007 (dollars are in thousands):

| As of June 30, 2008  | Less than 12 months |                   |                   | 12 months or more |                 |                | Total     |                   |                   |
|--|---------------------|-------------------|-------------------|-------------------|-----------------|----------------|-----------|-------------------|-------------------|
|  | #                   | Fair              | Unrealized        | #                 | Fair            | Unrealized     | #         | Fair              | Unrealized        |
|  |                     | Value             | Loss              |                   | Value           | Loss           |           | Value             | Loss              |
| U.S. government agency mortgage-backed securities guaranteed by GNMA | 2                   | \$ 1,189          | \$ (14)           | 1                 | \$ 83           | \$ (1)         | 3         | \$ 1,272          | \$ (15)           |
| U.S. government agency mortgage-backed securities issued by FNMA     | -                   | -                 | -                 | 3                 | 1,560           | (34)           | 3         | 1,560             | (34)              |
| Collateralized mortgage obligations issued by FNMA or FHLMC          | 1                   | 415               | -                 | -                 | -               | -              | 1         | 415               | -                 |
| Other collateralized mortgage obligations                            | 23                  | 110,168           | (3,574)           | -                 | -               | -              | 23        | 110,168           | (3,574)           |
| <b>Total temporarily impaired securities</b>                         | <b>26</b>           | <b>\$ 111,772</b> | <b>\$ (3,588)</b> | <b>4</b>          | <b>\$ 1,643</b> | <b>\$ (35)</b> | <b>30</b> | <b>\$ 113,415</b> | <b>\$ (3,623)</b> |

| As of December 31, 2007  | Less than 12 months |                  |                | 12 months or more |                 |                | Total     |                  |                 |
|--|---------------------|------------------|----------------|-------------------|-----------------|----------------|-----------|------------------|-----------------|
|  | #                   | Fair             | Unrealized     | #                 | Fair            | Unrealized     | #         | Fair             | Unrealized      |
|  |                     | Value            | Loss           |                   | Value           | Loss           |           | Value            | 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)            |
| <b>Total temporarily impaired securities</b>                         | <b>5</b>            | <b>\$ 12,218</b> | <b>\$ (65)</b> | <b>10</b>         | <b>\$ 6,092</b> | <b>\$ (54)</b> | <b>15</b> | <b>\$ 18,310</b> | <b>\$ (119)</b> |

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. None of the impairments were due to deterioration in credit quality that might result in the non-collection of contractual principal and interest. Further, we have both the intent and ability to hold these impaired securities for a sufficient period of time, until maturity if necessary, to allow for their recovery in market value.

## NOTE 11 – Fair Value Measurements

SFAS No. 157, *Fair Value Measurements* defines fair value and establishes a framework for measuring fair value of assets and liabilities using a hierarchy system consisting of three levels based on the markets in which

the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. These levels are:

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

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

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

The following table summarizes the financial assets and liabilities of the Company for which fair values are determined on a recurring basis as of June 30, 2008 (in thousands):

|   | <b>Carrying Value at June 30, 2008</b> |                |                   |                |                       |
|---|--|----------------|-------------------|----------------|-----------------------|
|   | <b>Total</b>                           | <b>Level 1</b> | <b>Level 2</b>    | <b>Level 3</b> | <b>Amortized Cost</b> |
| <b>ASSETS</b>                           |  |                |                   |                |                       |
| Securities available for sale           | \$ 200,312                             | \$ -           | \$ 200,312        | \$ -           | \$ 202,040            |
| Loans held for sale                     | 5,758                                  | -              | 5,758             | -              | 5,631                 |
| Commitments to originate mortgage loans | 117                                    | -              | 117               | -              | -                     |
| Interest rate floor                     | 1,043                                  | -              | 1,043             | -              | 531                   |
| <b>Total assets at fair value</b>       | <b>\$ 207,230</b>                      | <b>\$ -</b>    | <b>\$ 207,230</b> | <b>\$ -</b>    | <b>\$ 208,202</b>     |
| <b>LIABILITIES</b>                      |  |                |                   |                |                       |
| Commitments to sell mortgage loans      | \$ 245                                 | \$ -           | \$ 245            | \$ -           | \$ -                  |
| <b>Total liabilities at fair value</b>  | <b>\$ 245</b>                          | <b>\$ -</b>    | <b>\$ 245</b>     | <b>\$ -</b>    | <b>\$ -</b>           |

Changes in the fair value of assets and liabilities determined on a recurring basis had no net impact on our income statement for the three month and six month periods ending June 30, 2008.

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 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 in the six months of 2008 that were still held at June 30, 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 June 30, 2008 (in thousands):

|                               | <b>Carrying Value at June 30, 2008</b> |                |                  |                |
|-------------------------------|--|----------------|------------------|----------------|
|                               | <b>Total</b>                           | <b>Level 1</b> | <b>Level 2</b>   | <b>Level 3</b> |
| Impaired Loans <sup>(1)</sup> | \$ 16,721                              | \$ -           | \$ 16,721        | \$ -           |
| <b>Total</b>                  | <b>\$ 16,721</b>                       | <b>\$ -</b>    | <b>\$ 16,721</b> | <b>\$ -</b>    |

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

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 No. 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

non-recurring basis, until January 1, 2009. We are evaluating the impact, if any, the adoption of SFAS No. 157 for our nonfinancial assets and nonfinancial liabilities will have on our financial position, results of operations or liquidity.

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

For purposes of Items 2, 3 and 4 of Part I of this report, we refer to "we," "our" or the "Company" when such reference includes BNCCORP, Inc. and its consolidated subsidiaries, collectively; "BNCCORP" when referring only to BNCCORP, Inc.; the "Bank" when referring only to BNC National Bank; "BNC Insurance" when referring only to BNC Insurance Services, Inc.

### **Comparison of Results for the Three and Six Months Ended June 30, 2008 and 2007**

#### **Summary for the Three Months Ended June 30, 2008 and 2007**

##### **General**

Net income from continuing operations was \$700 thousand, or \$0.21 per share on diluted basis, for the quarter ended June 30, 2008. This compared to a net loss from continuing operations of \$1.977 million, or \$(0.56) per diluted share, in the second quarter of 2007.

##### **Continuing Operations**

Net interest income for the second quarter of 2008 was \$6.765 million, an increase of \$1.405 million, or 26.2%, from \$5.360 million in the same period of 2007. The net interest margin for the current period improved to 3.74% from 3.66%.

In the second quarter, the Company also increased the provision for credits losses to \$2.000 million compared to \$700 thousand in the same period of 2007.

Non-interest income for the second quarter of 2008 was \$3.358 million. This compares to non-interest losses of \$(284) thousand for the same period in 2007.

Non-interest expense for the second quarter of 2008 was \$7.078 million compared to \$7.739 million in the same period of 2007, a decrease of \$661 thousand, or 8.5%, compared to the same period in 2007.

The effective tax rate in was 33.0% in 2008 while a benefit of \$1.386 million was recorded in 2007.

##### **Discontinued Operations**

Net income from discontinued operations was \$3.804 million, or \$1.08 per diluted share in the 2007 period when the Company's former insurance segment was sold and generated a gain of \$6.083 million.

##### **Net Income**

Net income, which combines results of continuing operations and discontinued operations, was \$700 thousand, or \$0.21 per share on a diluted basis compared to net income of \$1.827 million, or \$0.52 per share on a diluted basis, in 2007.

#### **Summary for the Six Months Ended June 30, 2008 and 2007**

##### **General**

Net income from continuing operations was \$2.062 million, or \$0.61 per share on diluted basis, for the six months ended June 30, 2008. This compared to a net loss from continuing operations of \$1.716 million, or \$(0.49) per diluted share, in the second quarter of 2007.

### **Continuing Operations**

Net interest income for the six months ended June 30, 2008 was \$13.037 million, an increase of \$2.878 million, or 28.3%, from \$10.159 million in the same period of 2007. The net interest margin for the current period improved to 3.76% from 3.44%.

In the first six months of 2008, the Company also increased the provision for credits losses to \$2.800 million compared to \$950 thousand in the same period of 2007.

Non-interest income for the six months ended June 30, 2008 was \$5.658 million. This compares to non-interest income of \$1.413 million for the same period in 2007.

Non-interest expense for the six months ended June 30, 2008 was \$12.817 million compared to \$13.725 million in the same period of 2007, a decrease of \$908 thousand, or 6.6%, compared to the same period in 2007.

The effective tax rate in was 33.0% for the first six months ended June 30, 2008 while a benefit of \$1.387 million was recorded in 2007.

### **Discontinued Operations**

Net income from discontinued operations was \$5.100 million, or \$1.45 per diluted share in the 2007 period when the Company's former insurance segment was sold and generated a gain of \$6.083 million.

### **Net Income**

Net income, which combines results of continuing operations and discontinued operations, was \$2.062 million, or \$0.61 per share on a diluted basis compared to net income of \$3.384 million, or \$0.96 per share on a diluted basis, in 2007.

### **Net Interest Income from Continuing Operations**

The following table presents average balances; interest earned or owed; associated yields on interest-earning assets and costs on interest-bearing liabilities for the three-month periods ended June 30, 2008 and 2007 and the six-month periods ended June 30, 2008, and 2007, as well as the changes between the periods presented, (dollars are in thousands):

**Three Months Ended June 30,**

|  | 2008              |                         |                       | 2007              |                         |                       | Change            |                         |                       |
|--|-------------------|-------------------------|-----------------------|-------------------|-------------------------|-----------------------|-------------------|-------------------------|-----------------------|
|  | Average balance   | Interest earned or owed | Average yield or cost | Average balance   | Interest earned or owed | Average yield or cost | Average balance   | Interest earned or owed | Average yield or cost |
| <b>Interest-earning assets</b>               |                   |                         |                       |                   |                         |                       |                   |                         |                       |
| Federal funds sold/interest-bearing due from | \$ 11             | \$ -                    | 0.00%                 | \$ 10,122         | \$ 132                  | 5.23%                 | \$ (10,111)       | \$ (132)                | -5.23% (a)            |
| Investments - taxable                        | 164,078           | 2,402                   | 5.89%                 | 143,352           | 1,700                   | 4.76%                 | 20,726            | 702                     | 1.13% (b)             |
| Investments - tax exempt                     | 19,156            | 233                     | 4.89%                 | 18,892            | 231                     | 4.90%                 | 264               | 2                       | -0.01%                |
| Loans held for sale                          | 5,131             | 80                      | 6.27%                 | 709               | -                       | 0.00%                 | 4,422             | 80                      | 6.27%                 |
| Participating interests in mortgage loans    | 25,121            | 356                     | 5.70%                 | 29,153            | 596                     | 8.20%                 | (4,032)           | (240)                   | -2.50% (c)            |
| Loans and leases held for investment         | 520,678           | 8,425                   | 6.51%                 | 388,012           | 8,474                   | 8.76%                 | 132,666           | (49)                    | -2.25% (d)            |
| Allowance for loan losses                    | (6,764)           | -                       |                       | (3,629)           | -                       |                       | (3,135)           | -                       |                       |
| Total interest-earning assets                | <u>\$ 727,411</u> | <u>11,496</u>           | 6.36%                 | <u>\$ 586,611</u> | <u>11,133</u>           | 7.61%                 | <u>\$ 140,800</u> | <u>363</u>              | -1.25%                |
| <b>Interest-bearing liabilities</b>          |                   |                         |                       |                   |                         |                       |                   |                         |                       |
| Interest checking and money market accounts  | \$ 250,604        | 1,030                   | 1.65%                 | \$ 249,074        | 2,078                   | 3.35%                 | \$ 1,530          | (1,048)                 | -1.70%                |
| Savings                                      | 9,506             | 7                       | 0.30%                 | 8,520             | 17                      | 0.80%                 | 986               | (10)                    | -0.50%                |
| Certificates of deposit under \$100,000      | 186,779           | 1,760                   | 3.79%                 | 145,881           | 1,754                   | 4.82%                 | 40,898            | 6                       | -1.03% (e)            |
| Certificates of deposit \$100,000 and over   | <u>88,554</u>     | <u>961</u>              | 4.36%                 | <u>43,251</u>     | <u>554</u>              | 5.14%                 | <u>45,303</u>     | <u>407</u>              | -0.78% (e)            |
| Total interest-bearing deposits              | 535,443           | 3,758                   | 2.82%                 | 446,726           | 4,403                   | 3.95%                 | 88,717            | (645)                   | -1.13%                |
| Short-term borrowings                        | 5,563             | 28                      | 2.02%                 | 8,934             | 109                     | 4.89%                 | (3,371)           | (81)                    | -2.87%                |
| Federal Home Loan Bank advances              | 84,534            | 549                     | 2.61%                 | 45,169            | 691                     | 6.14%                 | 39,365            | (142)                   | -3.53% (f)            |
| Long-term borrowings                         | 1,380             | 15                      | 4.37%                 | -                 | -                       | 0.00%                 | 1,380             | 15                      | 4.37%                 |
| Subordinated debentures                      | <u>22,787</u>     | <u>381</u>              | 6.72%                 | <u>22,546</u>     | <u>570</u>              | 10.14%                | <u>241</u>        | <u>(189)</u>            | -3.42%                |
| Total borrowings                             | <u>114,264</u>    | <u>973</u>              | 3.42%                 | <u>76,649</u>     | <u>1,370</u>            | 7.17%                 | <u>37,615</u>     | <u>(397)</u>            | -3.75%                |
| Total interest-bearing liabilities           | <u>\$ 649,707</u> | <u>4,731</u>            | 2.93%                 | <u>\$ 523,375</u> | <u>5,773</u>            | 4.42%                 | <u>\$ 126,332</u> | <u>(1,042)</u>          | -1.49%                |
| Net interest income/spread                   |                   | <u>\$ 6,765</u>         | 3.43%                 |                   | <u>\$ 5,360</u>         | 3.19%                 |                   | <u>\$ 1,405</u>         | 0.24%                 |
| Net interest margin                          |                   |                         | 3.74%                 |                   |                         | 3.66%                 |                   |                         | 0.08%                 |
| Notation:                                    |                   |                         |                       |                   |                         |                       |                   |                         |                       |
| Non-interest-bearing deposits                | <u>\$ 66,472</u>  | -                       |                       | <u>\$ 68,887</u>  | -                       |                       | <u>\$ (2,415)</u> | -                       |                       |
| Total deposits                               | <u>\$ 601,915</u> | <u>\$ 3,758</u>         | 2.51%                 | <u>\$ 515,613</u> | <u>\$ 4,403</u>         | 3.43%                 | <u>\$ 86,302</u>  | <u>\$ (645)</u>         | -0.92%                |
| Taxable equivalents:                         |                   |                         |                       |                   |                         |                       |                   |                         |                       |
| Total interest-earning assets                | \$ 727,411        | \$ 11,618               | 6.42%                 | \$ 586,611        | \$ 11,255               | 7.70%                 | \$ 140,800        | \$ 363                  | -1.28%                |
| Net interest income/spread                   | -                 | \$ 6,887                | 3.49%                 | -                 | \$ 5,482                | 3.28%                 | -                 | \$ 1,405                | 0.21%                 |
| Net interest margin                          | -                 |                         | 3.81%                 | -                 | -                       | 3.75%                 | -                 | -                       | 0.06%                 |

- (a) The average balance of Federal funds sold is lower in 2008 as these funds have been used to fund increases in other interest earning assets.
- (b) The increase in average investments was primarily the result of a strategy to increase improve net interest income.
- (c) Participating interests in mortgage loans are collateralized by mortgage loans owned by a mortgage banking counterparty. We advance funds when the counterparty closes on loans and are repaid when the mortgage banking entity sells the loans. Our loans will vary depending on the level of originations and the timing of loan sales by the mortgage banking entity. The mortgage banking industry is currently operating in a challenging environment.
- (d) The average balance of loans has increased due to organic growth and repurchases of participations previously sold.
- (e) The average balance of CD's has increased partially because customers are migrating to fixed rate deposit products as rates have declined. These balances have also increased as brokered CD's have been used to fund asset growth.
- (f) The average balance of FHLB advances has increased in 2008 because short-term advances have been utilized as a funding source for assets expected to repay or re-price in the near term.

**Six Months Ended June 30,**

|  | 2008            |                         |                       | 2007            |                         |                       | Change          |                         |                       |
|--|-----------------|-------------------------|-----------------------|-----------------|-------------------------|-----------------------|-----------------|-------------------------|-----------------------|
|  | Average balance | Interest earned or owed | Average yield or cost | Average balance | Interest earned or owed | Average yield or cost | Average balance | Interest earned or owed | Average yield or cost |
| <b>Interest-earning assets</b>               |                 |                         |                       |                 |                         |                       |                 |                         |                       |
| Federal funds sold/interest-bearing due from | \$ 11           | \$ -                    | 0.00%                 | \$ 20,274       | \$ 522                  | 5.19%                 | \$ (20,263)     | \$ (522)                | -5.19% (a)            |
| Investments - taxable                        | 143,983         | 4,041                   | 5.64%                 | 154,555         | 3,620                   | 4.72%                 | (10,572)        | 421                     | 0.92%                 |
| Investments - tax exempt                     | 19,174          | 466                     | 4.89%                 | 18,851          | 462                     | 4.94%                 | 323             | 4                       | -0.05%                |
| Loans held for sale                          | 2,752           | 80                      | 5.85%                 | 543             | -                       | 0.00%                 | 2,209           | 80                      | 5.85%                 |
| Participating interests in mortgage loans    | 23,914          | 745                     | 6.26%                 | 35,336          | 1,408                   | 8.04%                 | (11,422)        | (663)                   | -1.78% (b)            |
| Loans and leases held for investment         | 513,783         | 17,549                  | 6.87%                 | 369,735         | 15,997                  | 8.72%                 | 144,048         | 1,552                   | -1.85% (c)            |
| Allowance for loan losses                    | (6,668)         |                         |                       | (3,500)         | -                       |                       | (3,168)         | -                       |                       |
| Total interest-earning assets                | \$ 696,949      | 22,881                  | 6.60%                 | \$ 595,794      | 22,009                  | 7.45%                 | \$ 101,155      | 872                     | -0.85%                |
| <b>Interest-bearing liabilities</b>          |                 |                         |                       |                 |                         |                       |                 |                         |                       |
| Interest checking and money market accounts  | \$ 243,666      | 2,343                   | 1.93%                 | \$ 253,011      | 4,183                   | 3.33%                 | \$ (9,345)      | (1,840)                 | -1.40%                |
| Savings                                      | 9,103           | 19                      | 0.42%                 | 8,497           | 33                      | 0.78%                 | 606             | (14)                    | -0.36%                |
| Certificates of deposit under \$100,000      | 186,244         | 3,801                   | 4.10%                 | 147,757         | 3,527                   | 4.81%                 | 38,487          | 274                     | -0.71% (d)            |
| Certificates of deposit \$100,000 and over   | 70,048          | 1,583                   | 4.54%                 | 43,661          | 1,117                   | 5.16%                 | 26,387          | 466                     | -0.62% (d)            |
| Total interest-bearing deposits              | 509,061         | 7,746                   | 3.06%                 | 452,926         | 8,860                   | 3.94%                 | 56,135          | (1,114)                 | -0.88%                |
| Short-term borrowings                        | 5,398           | 69                      | 2.57%                 | 9,413           | 219                     | 4.69%                 | (4,015)         | (150)                   | -2.12%                |
| Federal Home Loan Bank advances              | 80,014          | 1,168                   | 2.94%                 | 53,684          | 1,627                   | 6.11%                 | 26,330          | (459)                   | -3.17% (e)            |
| Long-term borrowings                         | 942             | 23                      | 4.91%                 | 188             | 9                       | 9.65%                 | 754             | 14                      | -4.74%                |
| Subordinated debentures                      | 22,737          | 838                     | 7.41%                 | 22,475          | 1,135                   | 10.18%                | 262             | (297)                   | -2.77%                |
| Total borrowings                             | 109,091         | 2,098                   | 3.87%                 | 85,760          | 2,990                   | 7.03%                 | 23,331          | (892)                   | -3.16%                |
| Total interest-bearing liabilities           | \$ 618,152      | 9,844                   | 3.20%                 | \$ 538,686      | 11,850                  | 4.44%                 | \$ 79,466       | (2,006)                 | -1.24%                |
| Net interest income/spread                   |                 | \$ 13,037               | 3.40%                 |                 | \$ 10,159               | 3.01%                 |                 | \$ 2,878                | 0.39%                 |
| Net interest margin                          |                 |                         | 3.76%                 |                 |                         | 3.44%                 |                 |                         | 0.32%                 |
| <b>Notation:</b>                             |                 |                         |                       |                 |                         |                       |                 |                         |                       |
| Non-interest-bearing deposits                | \$ 65,785       | -                       |                       | \$ 69,402       | -                       |                       | \$ (3,617)      | -                       |                       |
| Total deposits                               | \$ 574,846      | \$ 7,746                | 2.71%                 | \$ 522,328      | \$ 8,860                | 3.42%                 | \$ 52,518       | \$ (1,114)              | -0.71%                |
| <b>Taxable equivalents:</b>                  |                 |                         |                       |                 |                         |                       |                 |                         |                       |
| Total interest-earning assets                | \$ 696,949      | \$ 22,252               | 6.42%                 | \$ 595,794      | \$ 22,251               | 7.53%                 | \$ 101,155      | \$ 1                    | -1.11%                |
| Net interest income/spread                   | -               | \$ 12,408               | 3.22%                 | -               | \$ 10,401               | 3.09%                 | -               | \$ 2,007                | 0.13%                 |
| Net interest margin                          | -               |                         | 3.58%                 | -               |                         | 3.52%                 | -               |                         | 0.06%                 |

- (a) The average balance of Federal funds sold is lower in 2008, as these funds have been used to fund increases in other interest earning assets.
- (b) Participating interests in mortgage loans are collateralized by mortgage loans owned by a mortgage banking counterparty. We advance funds when the counterparty closes on loans and are repaid when the mortgage banking entity sells the loans. Our loans will vary depending on the level of originations and the timing of loan sales by the mortgage banking entity. The mortgage banking industry is currently operating in a challenging environment.
- (c) The average balance of loans has increased due to organic growth and repurchases of participations previously sold.
- (d) The average balance of CD's has increased partially because customers are migrating to fixed rate deposit products as rates have declined. These balances have also increased as brokered CD's have been used to fund asset growth.
- (e) The average balance of FHLB advances has increased in 2008 because short-term advances have been utilized as a funding source for assets expected to repay or re-price in the near term.

### **Non-interest Income from Continuing Operations**

The following table presents the major categories of our non-interest income for the three-month periods ended June 30, 2008 and 2007 and the six-month periods ended June 30, 2008 and 2007, as well as the amount and percent of change between the periods (dollars are in thousands):

| Non-interest Income                          | Three Months    |                 |                     |                  | Six Months Ended |                 |                     |              |
|--|-----------------|-----------------|---------------------|------------------|------------------|-----------------|---------------------|--------------|
|  | June 30,        |                 | Increase (Decrease) |                  | June 30,         |                 | Increase (Decrease) |              |
|  | 2008            | 2007            | \$                  | %                | 2008             | 2007            | \$                  | %            |
| Bank charges and service fees                | \$ 518          | \$ 558          | \$ (40)             | (7) %            | \$ 1,009         | \$ 1,099        | \$ (90)             | (8) %        |
| Wealth management revenues                   | 768             | 346             | 422                 | 122 %            | 1,524            | 802             | 722                 | 90 % (a)     |
| Mortgage banking revenues                    | 776             | 74              | 702                 | 949 %            | 750              | 115             | 635                 | 552 % (b)    |
| Gains on sales of loans                      | 253             | 614             | (361)               | (59) %           | 1,039            | 936             | 103                 | 11 % (c)     |
| Gain on sales of premises and equipment, net | 794             | -               | 794                 | 100 %            | 794              | -               | 794                 | 100 % (d)    |
| Net gain (loss) on sales of securities       | -               | (2,026)         | 2,026               | (100) %          | -                | (2,026)         | 2,026               | (100) % (e)  |
| Other  | 249             | 150             | 99                  | 66 %             | 542              | 487             | 55                  | 11 %         |
| Total non-interest income (loss)             | <u>\$ 3,358</u> | <u>\$ (284)</u> | <u>\$ 3,642</u>     | <u>(1,282) %</u> | <u>\$ 5,658</u>  | <u>\$ 1,413</u> | <u>\$ 4,245</u>     | <u>300 %</u> |

- (a) Wealth management income increased due to an increase of new products where BNC is compensated to assemble documents and act as a custodial trustee.
- (b) Mortgage banking revenues increased in the second quarter of 2008 after we acquired the fixed assets of a mortgage banking entity and hired several of its employees.
- (c) Our commercial real estate divisions originate and sell loans. The sales generate gains which are dependent on the volume of loans sold. This source of income is subject to variability from period to period. The gains on sales of commercial real estate loans are anticipated to moderate or decline, through the remainder of 2008, as the volume of loans sold is expected to diminish.
- (d) In the second of 2008 we sold a facility.
- (e) In the second quarter of 2007 we sold securities in order to improve net interest income in future periods.

### Non-interest Expense from Continuing Operations

The following table presents the major categories of our non-interest expense for the three-month periods ended June 30, 2008 and 2007 and the six-month periods ended June 30, 2008 and 2007, as well as the amount and percent of change between the periods (dollars are in thousands):

| Non-interest Expense  | Three Months Ended |                 |                     |              | Six Months Ended |                  |                     |              |
|---|--------------------|-----------------|---------------------|--------------|------------------|------------------|---------------------|--------------|
|   | June 30,           |                 | Increase (Decrease) |              | June 30,         |                  | Increase (Decrease) |              |
|   | 2008               | 2007            | \$                  | %            | 2008             | 2007             | \$                  | %            |
| Salaries and employee benefits                                | \$ 3,938           | \$ 3,674        | \$ 264              | 7 %          | \$ 7,361         | \$ 7,114         | \$ 247              | 3 %          |
| Occupancy   | 547                | 537             | 10                  | 2 %          | 989              | 1,074            | (85)                | (8) %        |
| Data processing fees  | 522                | 565             | (43)                | (8) %        | 931              | 1,166            | (235)               | (20) % (a)   |
| ORE expenses  | 402                | -               | 402                 | 100 %        | 402              | -                | 402                 | 100 % (b)    |
| Depreciation and amortization                                 | 327                | 429             | (102)               | (24) %       | 669              | 890              | (221)               | (25) % (c)   |
| Professional services   | 294                | 226             | 68                  | 30 %         | 482              | 380              | 102                 | 27 % (d)     |
| Marketing and promotion                                       | 267                | 159             | 108                 | 68 %         | 462              | 349              | 113                 | 32 %         |
| Office supplies, telephone and postage                        | 169                | 122             | 47                  | 39 %         | 376              | 253              | 123                 | 49 %         |
| FDIC and other assessments                                    | 56                 | 59              | (3)                 | (5) %        | 110              | 116              | (6)                 | (5) %        |
| Prepayment penalties on early extinguishment of FHLB advances | -                  | 1,535           | (1,535)             | (100) %      | -                | 1,535            | (1,535)             | (100) % (e)  |
| Other   | 556                | 433             | 123                 | 28 %         | 1,035            | 848              | 187                 | 22 %         |
| Total non-interest expense                                    | <u>\$ 7,078</u>    | <u>\$ 7,739</u> | <u>\$ (661)</u>     | <u>(9) %</u> | <u>\$ 12,817</u> | <u>\$ 13,725</u> | <u>(908)</u>        | <u>(7) %</u> |
| Efficiency ratio  | <u>69.9%</u>       | <u>152.5%</u>   |                     |              | <u>68.6%</u>     | <u>118.6%</u>    |                     |              |

- (a) Data processing costs decreased as a result of re-engineering operating procedures.

- (b) ORE expenses increased concurrently with foreclosure activities.
- (c) Depreciation and amortization declined because properties have been divested after the sale of BNC Insurance.
- (d) These expenses will vary from period to period depending on utilization.
- (e) In the second quarter of 2007 we prepaid advances in order to improve net interest income in future periods.

## Income Tax Provision in Continuing Operations

The effective tax rate in continuing operations during the second quarter of 2008 was 33.0%. In the second quarter of 2007 we recorded a tax benefits associated with losses incurred.

## Comparison of Financial Condition at June 30, 2008 and December 31, 2007

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

| Assets  | June 30,          | December 31,      | Increase (Decrease) |             |
|---|-------------------|-------------------|---------------------|-------------|
|   | 2008              | 2007              | \$                  | %           |
| Cash and cash equivalents                             | \$ 15,899         | \$ 14,856         | \$ 1,043            | 7 % (a)     |
| Investment securities available for sale              | 200,312           | 122,899           | 77,413              | 63 % (b)    |
| Federal Reserve Bank and Federal Home Loan Bank stock | 7,077             | 4,918             | 2,159               | 44 % (c)    |
| Loans held for sale                                   | 5,758             | -                 | 5,758               | 100 % (d)   |
| Participating interests in mortgage loans             | 25,333            | 24,357            | 976                 | 4 %         |
| Loans and leases held for investment, net             | 518,810           | 490,957           | 27,853              | 6 % (e)     |
| Other real estate                                     | 5,098             | -                 | 5,098               | 100 % (f)   |
| Premises and equipment, net                           | 20,674            | 19,448            | 1,226               | 6 %         |
| Interest receivable                                   | 3,255             | 3,290             | (35)                | (1) %       |
| Other assets  | 19,505            | 15,294            | 4,211               | 28 % (g)    |
| Premises and equipment held for sale, net             | -                 | 3,572             | (3,572)             | (100) % (h) |
| Total assets  | <u>\$ 821,721</u> | <u>\$ 699,591</u> | <u>\$ 122,130</u>   | 17 %        |

- (a) These balances typically vary significantly on a daily basis.
- (b) The increase in investments was primary the result of management's decision to leverage the balance sheet in order to increase net interest income.
- (c) Federal Reserve Bank stock and Federal Home Loan Bank stock balances increased as we were required to increase holdings when utilization of Federal Home Loan Bank advances increased.
- (d) Loans held for sale increased after we acquired the assets of a mortgage banking entity in the second quarter of 2008.
- (e) The balance of loans has increased due to organic growth.
- (f) During the second quarter of 2008 we acquired three properties through foreclosure activities.
- (g) Other assets have increased primarily due to deferred tax assets, prepaid expenses, cash surrender value of bank owned life insurance and increases in derivatives.
- (h) In the second quarter of 2008 we sold a facility previously used by the insurance segment.

## Loans and Leases Held For Investment Portfolio

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

|  | June 30, 2008     |              | December 31, 2007 |              | Increase (Decrease) |           |
|--|-------------------|--------------|-------------------|--------------|---------------------|-----------|
|  | Amount            | %            | Amount            | %            | Amount              | %         |
| Commercial and industrial                                    | \$ 130,967        | 24.1         | \$ 125,555        | 24.4         | \$ 5,412            | 4%        |
| Real estate mortgage   | 252,611           | 46.4         | 181,000           | 35.1         | 71,611              | 40% (a)   |
| Real estate construction                                     | 111,384           | 20.5         | 167,345           | 32.5         | (55,961)            | (33)% (a) |
| Agricultural   | 23,657            | 4.3          | 17,074            | 3.3          | 6,583               | 39% (b)   |
| Consumer/other   | 6,720             | 1.2          | 5,878             | 1.1          | 842                 | 14%       |
| Participating interests in mortgage loans                    | 25,333            | 4.7          | 24,357            | 4.7          | 976                 | 4%        |
| Lease financing  | 1,528             | 0.3          | 1,815             | 0.4          | (287)               | (16)%     |
| Total principal amount of loans                              | 552,200           | 101.5        | 523,024           | 101.5        | 29,176              | 6%        |
| Unearned income and net unamortized deferred fees and costs  | (992)             | (0.2)        | (1,111)           | (0.2)        | 119                 | (11)%     |
| Loans, net of unearned income and unamortized fees and costs | 551,208           | 101.3        | 521,913           | 101.3        | 29,295              | 6%        |
| Less allowance for credit losses                             | (7,065)           | (1.3)        | (6,599)           | (1.3)        | (466)               | 7%        |
| Net loans  | <u>\$ 544,143</u> | <u>100.0</u> | <u>\$ 515,314</u> | <u>100.0</u> | <u>\$ 28,829</u>    | 6%        |

(a) Real estate mortgage loans increased and construction loans decreased because construction projects have been completed and reclassified between categories.

(b) Agricultural loans will vary seasonally.

## Loan Participations

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

The sales of participations are accounted for pursuant to SFAS No. 140.

Loan participations sold on a nonrecourse basis to outside financial institutions were \$287.0 million as of June 30, 2008 and \$201.8 million as of December 31, 2007.

## Concentrations of Credit

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

|              | June 30, 2008     |             | December 31, 2007 |             |
|--------------|-------------------|-------------|-------------------|-------------|
|              | Amount            | %           | Amount            | %           |
| North Dakota | \$ 191,960        | 34%         | \$ 154,972        | 30%         |
| Minnesota    | 180,960           | 33          | 193,149           | 37          |
| Arizona      | 136,861           | 25          | 136,371           | 26          |
| Other        | 42,419            | 8           | 38,532            | 7           |
| Totals       | <u>\$ 552,200</u> | <u>100%</u> | <u>\$ 523,024</u> | <u>100%</u> |

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

|              | June 30, 2008     |             | December 31, 2007 |             |
|--------------|-------------------|-------------|-------------------|-------------|
| North Dakota | \$ 186,616        | 34%         | \$ 160,506        | 31%         |
| Arizona      | 120,366           | 22          | 120,931           | 23          |
| Minnesota    | 102,880           | 19          | 130,085           | 25          |
| Texas        | 39,074            | 7           | 26,966            | 5           |
| California   | 20,266            | 4           | 20,715            | 4           |
| Kentucky     | 11,000            | 2           | 9,916             | 2           |
| Wisconsin    | 10,495            | 2           | 5,573             | 1           |
| Georgia      | 6,602             | 1           | 6,566             | 1           |
| Idaho        | 5,774             | 1           | 5,621             | 1           |
| New York     | 5,654             | 1           | 4,155             | 1           |
| Arkansas     | 5,279             | 1           | 5,171             | 1           |
| Florida      | 5,222             | 1           | 2,862             | 1           |
| Other        | 32,972            | 5           | 23,957            | 4           |
| Totals       | <u>\$ 552,200</u> | <u>100%</u> | <u>\$ 523,024</u> | <u>100%</u> |

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 are as follows (in thousands):

|                                 | June 30, 2008     |            | December 31, 2007 |            |
|---------------------------------|-------------------|------------|-------------------|------------|
| Land and land development loans | \$ 68,516         | 13%        | \$ 78,992         | 15%        |
| Construction loans              | 34,080            | 6          | 68,849            | 13         |
| Totals                          | <u>\$ 102,596</u> | <u>19%</u> | <u>\$ 147,841</u> | <u>28%</u> |

Construction loans include loans for which construction is in process or nearly complete and the projects will either be sold or refinanced into permanent loans upon the completion of construction or a period of time thereafter.

### Loan Maturities (1)

The following table sets forth the remaining maturities of loans in each major category of our portfolio as of June 30, 2008 (in thousands):

|  | Over 1 year         |                  |                   |                  |                  | Total             |
|--|---------------------|------------------|-------------------|------------------|------------------|-------------------|
|  | One year<br>or less | through 5 years  |                   | Over 5 years     |                  |                   |
|  |                     | Fixed<br>rate    | Floating<br>rate  | Fixed<br>rate    | Floating<br>rate |                   |
| Commercial and industrial                    | \$ 85,779           | \$ 17,842        | \$ 6,357          | \$ 13,085        | \$ 7,905         | \$ 130,968        |
| Real estate mortgage                         | 69,310              | 44,746           | 69,052            | 28,575           | 40,928           | 252,611           |
| Real estate construction                     | 69,559              | 3,469            | 36,363            | 160              | 1,833            | 111,384           |
| Agricultural                                 | 13,248              | 5,890            | 145               | 1,563            | 2,811            | 23,657            |
| Consumer/other                               | 3,025               | 2,738            | 517               | 151              | 288              | 6,719             |
| Participating interests in<br>mortgage loans | 25,333              | -                | -                 | -                | -                | 25,333            |
| Lease financing                              | -                   | 1,528            | -                 | -                | -                | 1,528             |
| Total principal amount of loans              | <u>\$ 266,254</u>   | <u>\$ 76,213</u> | <u>\$ 112,434</u> | <u>\$ 43,534</u> | <u>\$ 53,765</u> | <u>\$ 552,200</u> |

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

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

## Allowance for Credit Losses

The following tables below set forth information regarding changes in our allowance for credit losses for the three month and six month periods ending June 30, 2008 and 2007 and certain ratios related to the allowance for credit losses (dollars are in thousands):

|  | Three Months Ended          |                   | Six Months Ended          |                 |
|--|-----------------------------|-------------------|---------------------------|-----------------|
|  | June 30,                    |                   | June 30,                  |                 |
|  | 2008                        | 2007              | 2008                      | 2007            |
| <b>Balance, beginning of period</b>  | \$ 7,178                    | \$ 3,615          | \$ 6,599                  | \$ 3,370        |
| Provision for credit losses  | 2,000                       | 700               | 2,800                     | 950             |
| Loans charged off  | (2,145)                     | (8)               | (2,377)                   | (14)            |
| Loans recovered  | 32                          | 1                 | 43                        | 2               |
| <b>Balance, end of period</b>  | <u>\$ 7,065</u>             | <u>\$ 4,308</u>   | <u>\$ 7,065</u>           | <u>\$ 4,308</u> |
| Total loans at June 30, 2008 and June 30, 2007   | <u>\$ 556,966</u>           | <u>\$ 442,399</u> |                           |                 |
| Loans and leases held for investment at June 30, 2008 and June 30, 2007  | <u>\$ 525,875</u>           | <u>\$ 423,975</u> |                           |                 |
| Allowance for credit losses as a percentage of total loans at June 30, 2008 and June 30, 2007                          | 1.27%                       | 0.97%             |                           |                 |
| Allowance for credit losses as a percentage of loans and leases held for investment at June 30, 2008 and June 30, 2007 | 1.34%                       | 1.02%             |                           |                 |
|  | Three Months Ended June 30, |                   | Six Months Ended June 30, |                 |
|  | 2008                        | 2007              | 2008                      | 2007            |
| Ratio of net charge-offs to average total loans  | (0.384)%                    | (0.002)%          | (0.432)%                  | (0.003)%        |
| Ratio of net charge-offs to average loans and leases held for investment   | (0.406)%                    | (0.002)%          | (0.454)%                  | (0.003)%        |
| Ratio of net charge-offs to average total loans, annualized  | (1.534)%                    | (0.007)%          | (0.864)%                  | (0.006)%        |
| Ratio of net charge-offs to average loans and leases held for investment, annualized                                   | (1.623)%                    | (0.007)%          | (0.909)%                  | (0.006)%        |

The provision for credit losses was \$2.000 million in the second quarter of 2008 compared with \$700 thousand in the second quarter of 2007. The provision for credit losses increased due to loan growth and the Company's response to the general decline in asset values in the current environment.

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

|  | <b>Six Months Ended<br/>June 30, 2008</b> | <b>Year Ended<br/>December 31, 2007</b> |
|--|---|---|
| Balance of allowance for credit losses, beginning of period                  | \$ 6,599                                  | \$ 3,370                                |
| <b>Charge-offs:</b>  |   |   |
| Commercial and industrial  | 557                                       | 1,504                                   |
| Real estate mortgage   | 359                                       | 500                                     |
| Real estate construction   | 1,440                                     | -                                       |
| Agricultural   | -   | -                                       |
| Consumer/other   | 21  | 123                                     |
| Lease financing  | -   | -                                       |
| Total charge-offs  | <u>2,377</u>                              | <u>2,127</u>                            |
| <b>Recoveries:</b>   |   |   |
| Commercial and industrial  | 34  | 1,500                                   |
| Real estate mortgage   | -   | -                                       |
| Real estate construction   | -   | -                                       |
| Agricultural   | -   | -                                       |
| Consumer/other   | 9   | 106                                     |
| Lease financing  | -   | -                                       |
| Total recoveries   | <u>43</u>                                 | <u>1,606</u>                            |
| Net charge-offs  | <u>(2,334)</u>                            | <u>(521)</u>                            |
| Provision for credit losses charged to operations                            | 2,800                                     | 3,750                                   |
| Balance of allowance for credit losses, end of period                        | <u>\$ 7,065</u>                           | <u>\$ 6,599</u>                         |
| Ratio of net charge-offs to average total loans                              | <u>(0.384)%</u>                           | <u>(0.121)%</u>                         |
| Ratio of net charge-offs to average loans and leases held for investment     | <u>(0.406)%</u>                           | <u>(0.129)%</u>                         |
| Average gross loans and leases held for investment                           | <u>\$ 513,783</u>                         | <u>\$ 402,615</u>                       |
| Ratio of allowance for credit losses to loans and leases held for investment | <u>1.34%</u>                              | <u>1.33%</u>                            |
| Ratio of allowance for credit losses to nonperforming loans                  | <u>90%</u>                                | <u>122%</u>                             |

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

## Allocation of the Allowance for Loan Losses

|   | June 30,<br>2008          |  | December 31,<br>2007      |  |
|---|---------------------------|--|---------------------------|--|
|   | Amount<br>of<br>allowance | Loans in<br>category as a<br>percentage<br>of total<br>gross loans | Amount<br>of<br>Allowance | Loans in<br>category as a<br>percentage<br>of total<br>gross loans |
| Commercial and industrial                 | \$ 1,230                  | 24%  | \$ 1,410                  | 24%  |
| Real estate mortgage                      | 2,233                     | 46%  | 1,956                     | 35%  |
| Real estate construction                  | 2,889                     | 20%  | 2,740                     | 32%  |
| Agricultural                              | 384                       | 4%   | 276                       | 3%   |
| Consumer/other                            | 229                       | 1%   | 112                       | 1%   |
| Participating interests in mortgage loans | 84                        | 5%   | 85                        | 5%   |
| Lease financing                           | 16                        | -  | 20                        | -  |
| Total                                     | <u>\$ 7,065</u>           | <u>100%</u>  | <u>\$ 6,599</u>           | <u>100%</u>  |

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

The allowance for loan loss has increased in our real estate portfolios because these are the portions of our total portfolio where deterioration has occurred.

### Nonperforming Assets

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

|  | June 30,<br>2008 | December 31,<br>2007 |
|--|------------------|----------------------|
| <b>Nonperforming loans:</b>  |                  |                      |
| Loans 90 days or more delinquent and still accruing interest               | \$ 639           | \$ -                 |
| Non-accrual loans  | 7,184            | 5,399                |
| <b>Total nonperforming loans</b>   | <u>7,823</u>     | <u>5,399</u>         |
| Other real estate  | 5,098            |                      |
| <b>Total nonperforming assets</b>  | <u>\$ 12,921</u> | <u>\$ 5,399</u>      |
| Allowance for credit losses  | <u>\$ 7,065</u>  | <u>\$ 6,599</u>      |
| Ratio of total nonperforming loans to total loans                          | 1.40%            | 1.03%                |
| Ratio of total nonperforming loans to loans and leases held for investment | 1.49%            | 1.09%                |
| Ratio of total nonperforming assets to total assets                        | 1.57%            | 0.77%                |
| Ratio of allowance for credit losses to nonperforming loans                | 90%              | 122%                 |

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

### Non-accrual loans

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

At June 30, 2008 the Bank had \$18.4 million of classified loans and \$7.2 million of loans on non-accrual. This compares to \$16.4 million of classified loans and \$5.4 million of loans on non-accrual at December 31, 2007. The increase in non-accrual loans is primarily attributed to the deterioration of one residential development.

The following table indicates the effect on income if interest on non-accrual and restructured loans outstanding at year end had been recognized at original contractual rates during the quarter ended June 30, 2008 (in thousands):

|   | <b>Three Months<br/>Ended<br/>June 30, 2008</b> |     | <b>Six Months Ended<br/>June 30, 2008</b> |     |
|---|---|-----|---|-----|
| Interest income that would have been recorded | \$  | 106 | \$  | 221 |
| Interest income recorded                      |   | 42  |   | 126 |
| Effect on interest income                     | \$  | 64  | \$  | 95  |

### Impaired Loans

Impaired loans generally include loans on 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 non-accrual and restructured loans, as impaired loans.

As of June 30, 2008 and December 31, 2007, the Bank's recorded investment in impaired loans and the related valuation allowance was as follows (in thousands):

|                                 | <b>June 30, 2008</b>           |                                | <b>December 31, 2007</b>       |                                |
|---------------------------------|--------------------------------|--------------------------------|--------------------------------|--------------------------------|
|                                 | <b>Recorded<br/>Investment</b> | <b>Valuation<br/>Allowance</b> | <b>Recorded<br/>Investment</b> | <b>Valuation<br/>Allowance</b> |
| Impaired loans -                |                                |                                |                                |                                |
| Valuation allowance required    | \$ 18,354                      | \$ 1,687                       | \$ 16,397                      | \$ 1,572                       |
| No valuation allowance required | -                              | -                              | -                              | -                              |
| Total impaired loans            | \$ 18,354                      | \$ 1,687                       | \$ 16,397                      | \$ 1,572                       |

The valuation allowance on impaired loans is included in the Bank's allowance for credit losses. The average recorded investment in impaired loans as of June 30, 2008 and December 31, 2007, and approximate interest income for the three months and six months ended June 30, 2008 and June 30, 2007 recognized for such loans, were as follows (dollars are in thousands):

|   | <u>June 30, 2008</u>                        | <u>December 31, 2007</u>                    |
|---|---|---|
| Average recorded investment in impaired loans   | \$ 18,405                                   | \$ 16,228                                   |
| Average recorded investment in impaired loans<br>as a percentage of average total loans | <u>3.49%</u>                                | <u>3.26%</u>                                |
|   | <u>Three Months Ended<br/>June 30, 2008</u> | <u>Three Months Ended<br/>June 30, 2007</u> |
| Interest income recognized on impaired loans  | \$ 108                                      | \$ 17                                       |
| Interest income recognized on a cash basis<br>during the time of impairment             | <u>\$ -</u>                                 | <u>\$ -</u>                                 |
|   | <u>Six Months Ended<br/>June 30, 2008</u>   | <u>Six Months Ended<br/>June 30, 2007</u>   |
| Interest income recognized on impaired loans  | \$ 231                                      | \$ 31                                       |
| Interest income recognized on a cash basis<br>during the time of impairment             | <u>\$ 10</u>                                | <u>\$ -</u>                                 |

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

### **Restructured Loans**

Restructured loans are those for which concessions, including a reduction of the interest rate or the deferral of interest or principal, have been granted due to the borrower's weakened financial condition. Interest on restructured loans is accrued at the restructured rates when it is anticipated that no loss of original principal will occur. We had restructured loans aggregating \$2.5 million at June 30, 2008 and \$2.6 million at December 31, 2007. All restructured loans are included in non-accrual loans.

### **Potential Problem Loans**

In many regions of the country, asset values are in decline. So long as this decline continues credit problems in our portfolio are likely to increase.

Potential problem loans at June 30, 2008 totaled \$10.2 million compared to \$4.5 million at December 31, 2007. A significant portion of these potential problem loans are not in default but may have characteristics such as recent adverse operating cash flows or general risk characteristics that the loan officer feels might jeopardize the future timely collection of principal and interest payments. The ultimate resolution of these credits is subject to changes in economic conditions and other factors. These loans are closely monitored to ensure that our position as creditor is protected to the fullest extent possible.

### **Other Real Estate**

Other real estate (ORE) includes property acquired through foreclosure, property in judgment and in-substance foreclosures. ORE is carried at lower of cost or market. The property is evaluated regularly and any decreases in the carrying amount are included in noninterest expense.

|  | June 30,<br>2008 | December 31,<br>2007 | Increase (Decrease) |              |
|--|------------------|----------------------|---------------------|--------------|
|  |                  |                      | \$                  | %            |
| <b>Other Real Estate</b>               |                  |                      |                     |              |
| Other real estate owned                | \$ 2,758         | \$ -                 | \$ 2,758            | 100 %        |
| Real estate in judgment                | -                | -                    | -                   | -            |
| In-substance foreclosure               | 2,340            | -                    | 2,340               | 100 %        |
| <b>Total other real estate</b>         | <b>\$ 5,098</b>  | <b>\$ -</b>          | <b>\$ 5,098</b>     | <b>100 %</b> |
| Allowance for other real estate losses | -                | -                    | -                   | -            |
| <b>Total other real estate, net</b>    | <b>\$ 5,098</b>  | <b>\$ -</b>          | <b>\$ 5,098</b>     | <b>100 %</b> |

## Liabilities

The following table presents our liabilities by category as of June 30, 2008 and December 31, 2007 as well as the amount and percent of change between the two dates (dollars are in thousands):

| Liabilities  | June 30,<br>2008  | December 31,<br>2007 | Increase (Decrease) |             |
|--|-------------------|----------------------|---------------------|-------------|
|  |                   |                      | \$                  | %           |
| Deposits:  |                   |                      |                     |             |
| Non-interest-bearing   | \$ 64,832         | \$ 72,234            | \$ (7,402)          | (10) % (a)  |
| Interest-bearing -   |                   |                      |                     |             |
| Savings, interest checking and money market                                    | 271,844           | 245,722              | 26,122              | 11 % (b)    |
| Time deposits \$100,000 and over   | 114,550           | 44,038               | 70,512              | 160 % (c)   |
| Other time deposits  | 174,113           | 179,880              | (5,767)             | (3) %       |
| Short-term borrowings  | 6,206             | 5,365                | 841                 | 16 %        |
| Federal Home Loan Bank advances  | 102,000           | 61,400               | 40,600              | 66 % (d)    |
| Long-term borrowings   | -                 | -                    | -                   | -           |
| Guaranteed preferred beneficial interests in Company's subordinated debentures | 22,974            | 23,075               | (101)               | -           |
| Accrued interest payable   | 2,992             | 2,843                | 149                 | 5 %         |
| Accrued expenses   | 3,136             | 3,387                | (251)               | (7) %       |
| Other liabilities  | 2,133             | 1,917                | 216                 | 11 %        |
| <b>Total liabilities</b>   | <b>\$ 764,780</b> | <b>\$ 639,861</b>    | <b>\$ 124,919</b>   | <b>20 %</b> |

- (a) These accounts generally fluctuate daily due to the cash management activities of our customers, particularly our commercial customers.
- (b) Increase is due to the opening of the Glendale, Arizona branch, growth in deposits from the Wealth Management segment as well as growth in most of the North Dakota branches.
- (c) Certificates of deposits have increased partially because our customers have shifted to fixed rate products in a declining rate environment. CD's have also increased because we used brokered CD's to fund increases in investments.
- (d) FHLB advances are higher because we have used short term advances to fund assets that are expected to repay or re-price in the near term.

## Stockholders' Equity

Our stockholders' equity decreased \$2.789 million between December 31, 2007 and June 30, 2008. The decrease in stockholders' equity is a result of the repurchase of 200,326 shares of treasury stock offset by earnings.

## Capital Adequacy

We actively monitor compliance with regulatory capital requirements, including risk-based and leverage capital measures. Under the risk-based capital method of capital measurement, the ratio computed is dependent upon the amount and composition of assets recorded on the balance sheet, the amount and composition of off-balance-sheet items, and the amount of capital. The following table includes the risk-based and leverage capital ratios of the Company and the Bank (dollars are in thousands):

|  | Actual    |        | For Capital Adequacy Purposes |       | To be Well Capitalized Under Prompt |        |
|--|-----------|--------|-------------------------------|-------|-------------------------------------|--------|
|  | Amount    | Ratio  | Amount                        | Ratio | Amount                              | Ratio  |
| <b>June 30, 2008</b>                             |           |        |                               |       |                                     |        |
| <b>Total Capital</b> (to risk-weighted assets):  |           |        |                               |       |                                     |        |
| Consolidated                                     | \$ 87,131 | 12.99% | \$ 53,664                     | ≥8.0% | \$ N/A                              | N/A    |
| BNC National Bank                                | 86,810    | 12.93  | 53,693                        | ≥8.0  | 67,116                              | ≥10.0% |
| <b>Tier 1 Capital</b> (to risk-weighted assets): |           |        |                               |       |                                     |        |
| Consolidated                                     | 76,258    | 11.37  | 26,832                        | ≥4.0  | N/A                                 | N/A    |
| BNC National Bank                                | 79,744    | 11.88  | 26,846                        | ≥4.0  | 40,270                              | ≥6.0   |
| <b>Tier 1 Capital</b> (to average assets):       |           |        |                               |       |                                     |        |
| Consolidated                                     | 76,258    | 9.76   | 31,264                        | ≥4.0  | N/A                                 | N/A    |
| BNC National Bank                                | 79,744    | 10.20  | 31,265                        | ≥4.0  | 39,081                              | ≥5.0   |
| <b>December 31, 2007</b>                         |           |        |                               |       |                                     |        |
| <b>Total Capital</b> (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% |
| <b>Tier 1 Capital</b> (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   |
| <b>Tier 1 Capital</b> (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   |

As of June 30, 2008, BNCCORP and the Bank exceeded capital adequacy requirements and the Bank was considered “well-capitalized” under prompt corrective action provisions.

## Liquidity Risk Management

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

The Consolidated Statements of Cash Flows in the Consolidated Financial Statements present data on cash and cash equivalents provided by and used in operating, investing and financing activities. In addition to liquidity from core deposit growth, together with repayments and maturities of loans and investments, we utilize brokered deposits, sell securities under agreements to repurchase and borrow overnight Federal funds. The Bank is a member of the FHLB, which affords it the opportunity to borrow funds in terms ranging from overnight to 10 years and beyond. Advances from the FHLB are collateralized by the Bank’s mortgage loans and various investment securities. We have also obtained funding through the issuance of subordinated notes, subordinated debentures and long-term borrowings.

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

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

As of June 30, 2008, the Bank had established Federal funds purchase programs with three banks, totaling \$17.5 million. At June 30, 2008, the Bank had purchased Federal funds of \$0 under these programs leaving \$17.5 million available. The Federal funds purchase programs, if advanced upon, mature daily with interest rates that float at the Federal funds rate. The Bank has also been approved for repurchase agreement lines of up to \$100.0 million with a major financial institution. The lines, if utilized, would be collateralized by investment securities.

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

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

Our primary tool for measuring and managing interest rate risk is net interest income simulation. This exercise includes our assumptions regarding the changes in interest rates and the impact on our current balance sheet. Interest rate caps and floors are included to the extent that they are exercised in the 12-month simulation period. Additionally, changes in prepayment behavior of the residential mortgage, CMOs, and mortgage-backed securities portfolios in each rate environment are captured using industry estimates of prepayment speeds for various coupon segments of the portfolio. For purposes of this simulation, projected month-end balances of the various balance sheet accounts are held constant at their June 30, 2008 levels. Cash flows from a given account are reinvested back into the same account so as to keep the month-end balance constant at its June 30, 2008 level. The static balance sheet assumption is made so as to project the interest rate risk to net interest income embedded in the existing balance sheet. With knowledge of the balance sheet's existing net interest income profile, more informed strategies and tactics may be developed as it relates to the structure/mix of growth.

We monitor the results of net interest income simulation on a quarterly basis at regularly scheduled ALCO meetings. Each quarter net interest income is generally simulated for the upcoming 12-month horizon in seven interest scenarios. The scenarios generally modeled are parallel interest ramps of +/- 100bp, 200bp, and 300bp along with a rates unchanged scenario. The parallel movement of interest rates means all projected market interest rates move up or down by the same amount. A ramp in interest rates means that the projected change in market interest rates occurs over the 12-month horizon on a pro-rata basis. For example, in the -100bp scenario, the projected prime rate will decrease from its starting point at June 30, 2008 of 5.00% to 4.00% 12 months later. The prime rate in this example will decrease 1/12th of the overall decrease of 100 basis points each month. The net interest income simulation results for the 12-month horizon are shown below (dollars are in thousands):

### Net Interest Income Simulation

| Movement in interest rates                | <u>-300bp</u> | <u>-200bp</u> | <u>-100bp</u> | <u>Unchanged</u> | <u>+100bp</u> | <u>+200bp</u> | <u>+300bp</u> |
|---|---------------|---------------|---------------|------------------|---------------|---------------|---------------|
| Projected 12-month net interest income    | \$ 31,065     | \$ 30,844     | \$ 29,646     | \$ 28,898        | \$ 28,633     | \$ 28,395     | \$ 28,261     |
| Dollar change from unchanged scenario     | \$ 2,167      | \$ 1,946      | \$ 748        | -                | \$ (265)      | \$ (503)      | \$ (637)      |
| Percentage change from unchanged scenario | 7.50%         | 6.73%         | 2.59%         | -                | (0.92)%       | (1.74)%       | (2.20)%       |
| Policy guidelines (decline limited to)    | (10.00)%      | (10.00)%      | (5.00)%       | -                | (5.00)%       | (10.00)%      | (15.00)%      |

Because one of the objectives of asset/liability management is to manage net interest income over a one-year planning horizon, policy guidelines are stated in terms of maximum potential percentage reduction in net interest income resulting from changes in interest rates over the 12-month period. It is no less important, however, to give attention to the absolute dollar level of projected net interest income over the 12-month period.

Our general policy is to limit the percentage decrease in projected net interest income to 5, 10, and 15 percent from the rates unchanged scenario for the +/- 100bp, 200bp, and 300bp interest rate ramp scenarios, respectively. When a given scenario falls outside of these limits, the ALCO reviews the circumstances surrounding the exception and, considering the level of net interest income generated in the scenario and other related factors, may approve the exception to the general policy or recommend actions aimed at bringing the respective scenario within the general limits noted above.

Since there are limitations inherent in any methodology used to estimate the exposure to changes in market interest rates, these analyses are not intended to be a forecast of the actual effect of changes in market interest rates such as those indicated above on the Company. Further, these analyses are based on our assets and liabilities as of June 30, 2008 (without forward adjustments for planned growth and anticipated business activities) and do not contemplate any actions we might undertake in response to changes in market interest rates.

Static gap analysis is another tool that may be used for interest rate risk measurement. The net differences between the amount of assets, liabilities, equity and off-balance-sheet instruments repricing within a cumulative calendar period is typically referred to as the "rate sensitivity position" or "gap position." The following table sets forth our rate sensitivity position as of June 30, 2008. Assets and liabilities are classified by the earliest possible repricing date or maturity, whichever occurs first.

## Interest Sensitivity Gap Analysis

|   | Estimated maturity or repricing at June 30, 2008 |                   |                   |                  | Total             |
|---|--|-------------------|-------------------|------------------|-------------------|
|   | 0-3<br>months                                    | 4-12<br>months    | 1-5<br>years      | Over<br>5 years  |                   |
|   | (dollars are in thousands)                       |                   |                   |                  |                   |
| <b>Interest-earning assets:</b>               |  |                   |                   |                  |                   |
| Interest-bearing deposits with banks          | \$ -   | \$ -              | \$ -              | \$ -             | \$ -              |
| Investment securities                         | 10,567   | 26,954            | 95,706            | 67,085           | 200,312           |
| FRB and FHLB stock                            | 7,077  | -                 | -                 | -                | 7,077             |
| Fed Funds Sold                                | -  | -                 | -                 | -                | -                 |
| Loans held for sale, fixed rate               | -  | -                 | -                 | -                | -                 |
| Loans held for sale, floating rate            | -  | 31,091            | -                 | -                | 31,091            |
| Loans held for investment, fixed rate         | 27,433   | 41,719            | 74,349            | 19,335           | 162,836           |
| Loans held for investment, floating rate      | 330,023  | 3,822             | 26,148            | 3,046            | 363,039           |
| <b>Total interest-earning assets</b>          | <b>\$ 375,100</b>                                | <b>\$ 103,586</b> | <b>\$ 196,203</b> | <b>\$ 89,466</b> | <b>\$ 764,355</b> |
| <b>Interest-bearing liabilities:</b>          |  |                   |                   |                  |                   |
| Interest checking and money market            | \$ 261,919                                       | \$ -              | \$ -              | \$ -             | \$ 261,919        |
| Savings                                       | 9,925  | -                 | -                 | -                | 9,925             |
| Time deposits under \$100,000                 | 29,186   | 60,700            | 75,488            | 8,739            | 174,113           |
| Time deposits \$100,000 and over              | 23,154   | 21,193            | 70,203            | -                | 114,550           |
| Short-term borrowings                         | 6,206  | -                 | -                 | -                | 6,206             |
| FHLB advances                                 | 87,000   | -                 | 15,000            | -                | 102,000           |
| Long-term borrowings                          | -  | -                 | -                 | -                | -                 |
| Subordinated debentures                       | -  | -                 | -                 | 22,974           | 22,974            |
| <b>Total interest-bearing liabilities</b>     | <b>\$ 417,390</b>                                | <b>\$ 81,893</b>  | <b>\$ 160,691</b> | <b>\$ 31,713</b> | <b>\$ 691,687</b> |
| Interest rate gap                             | \$ (42,290)                                      | \$ 21,693         | \$ 35,512         | \$ 57,753        | \$ 72,668         |
| Cumulative interest rate gap at June 30, 2008 | \$ (42,290)                                      | \$ (20,597)       | \$ 14,915         | \$ 72,668        |                   |
| Cumulative interest rate gap to total assets  | (5.15%)  | (2.51%)           | 1.82%             | 8.84%            |                   |

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

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

Since there are limitations inherent in any methodology used to estimate the exposure to changes in market interest rates, these analyses are not intended to be a forecast of the actual effect of changes in market interest rates such as those indicated above on the Company. Further, these analyses are based on our assets and liabilities as of June 30, 2008 and do not contemplate any actions we might undertake in response to changes in market interest rates.

## **Other Information**

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

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

### **Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

In the second quarter of 2008 the Company repurchased 14,531 of its previously outstanding shares for approximately \$171,000 at an average cost of \$11.58 per share.

## Signatures

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

BNCCORP, Inc.

Date: August 14, 2008

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

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