

2012 Annual Report



BNCCORP, INC.





BNCCORP, INC. (BNCCORP or the Company) is a bank holding company registered under the Bank Holding Company Act of 1956, headquartered in Bismarck, North Dakota. It is the parent company of BNC National Bank (the Bank). The Company operates community banking and wealth management businesses in Arizona, Minnesota and North Dakota from 14 locations. BNC also conducts mortgage banking from 12 locations in Arizona, Minnesota, North Dakota, Illinois, Kansas, Nebraska and Missouri.



GREGORY K. CLEVELAND
President and Chief Executive Officer

TO OUR SHAREHOLDERS, CUSTOMERS, EMPLOYEES AND COMMUNITY:

“Our performance during the past year was highlighted by our strong fundamental earnings power, solid capital foundation, and sharp focus on providing community banking services for an attractive and vibrant market.”

I am pleased to report that BNCCORP delivered outstanding operational and financial results in 2012. Our performance during the past year was highlighted by our strong fundamental earnings power, solid capital foundation, and sharp focus on providing community banking services for an attractive and vibrant market. In addition to these and other positive developments, we can truly say that this was the period when BNC achieved the “escape velocity” to break free of the effects of the Great Recession that have weighed down the performance of so many financial institutions in recent years.

As a result of our progress, the Company entered 2013 in the strongest position we’ve been in for several years—and we have the forward momentum to deliver growing shareholder value in the months and years ahead.

Meaningful Financial Progress

Net income was \$26.6 million for 2012 (before preferred stock costs), a sharp increase over the \$4.2 million reported in 2011. Diluted earnings per common share were \$7.52 for 2012, up from \$0.86 for the prior year. These results represented a healthy return on average assets of 3.74% and a return on average common equity of 76.77%.

Earnings benefitted from a sharp increase in non-interest income, largely driven by our mortgage banking business, as well as decreased credit costs. In addition to our profitable operations, the Company recognized a tax benefit of some \$5.3 million in 2012, primarily due to the reversal of a significant portion of our valuation allowance on deferred tax assets. We also received \$7.5 million as a settlement of an insurance claim related to the fraudulent activity by an outside residential mortgage loan servicing provider as reported in 2010.

In recent years, we have focused on several priorities that we believe are vital for the long-term stability of the Company: credit quality, liquidity and capital. We made strides in all three areas in 2012.

The provision for credit losses declined to \$100 thousand in 2012, from \$1.6 million in 2011. Nonperforming assets were \$15.6 million or 2.03% of total assets at year-end 2012, down from \$16.3 million or 2.45% at the end of 2011. The allowance for credit losses as a percentage of total loans at December 31, 2012 was 2.62%, compared to 2.94% at December 31, 2011. We remain vigilant with respect to asset quality, and will continue to take reasonable and prudent measures to properly manage credit risk.

Total assets rose to \$770.8 million at year-end 2012, an increase of \$105.7 million during the past 12 months. A key contributor to our asset growth was the \$79.4 million increase in cash and investment securities since year-end 2011, due to our continued emphasis on liquidity. In addition, in 2012 we had higher balances of loans held for sale as a result of mortgage banking operations.



In terms of capital, our total common stockholders' equity at year-end 2012 was \$47.8 million, more than twice the level of a year ago, without resorting to an equity offering. Our book value per common share increased substantially to \$14.49 at December 31, 2012, from \$6.42 a year earlier. The Bank's capital ratios are well in excess of the regulatory standards for "well capitalized" institutions.

Core Banking for Our Communities

BNC has successfully focused on growing our business by providing superior banking and financial services solutions. For example, anticipating the recovery of the housing market from the depths of the recession, we increased our emphasis on mortgage banking—originating a record of over \$1 billion in mortgages in the past year. We also have emphasized other core banking services that are responsive to the needs of our markets, such as commercial and industrial lending in North Dakota (including financing for owner-occupied commercial real estate), and Small Business Administration loans in Arizona.

Total deposits at year-end 2012 were \$649.6 million, an increase of \$73.3 million. This was largely due to deposit growth at our North Dakota branch offices, which are well-positioned to continue to benefit from the vitality of this robust market.

Continuing our commitment to the wealth management business, we sponsored a well-attended wealth management seminar in Bismarck in October 2012, featuring the nationally recognized economist and financial writer John Mauldin. We had an opportunity to acquaint Mr. Mauldin with the strength of the local economy, and particularly its role in U.S. energy independence, leading to a favorable mention of BNC in his online newsletter in December.

The above are just a few examples of our strong community banking emphasis. A dedication to serving the communities in which we live and work sets off a virtuous cycle: our services help to grow local businesses and the financial well-being of our neighbors, who in turn support the growth of BNC. We're proud of the involvement of our employees in the community—both in providing exceptional service and participating in volunteer activities and charitable works. We look forward to growing our pool of talented, skilled and engaged people in the years to come.

Challenges and Opportunities

Admittedly, the current economic environment presents a number of challenges. The recession led to a significant expansion in banking regulations and historically low interest rates, both of which will continue to press upon the financial performance of companies in our industry. We also remain concerned about the lack of a clear, consistent approach to our nation's fiscal issues.

That said, BNCCORP enters 2013 with powerful forward momentum and we are well positioned to benefit from the opportunities we see in our business and marketplace. We have a solid core community banking franchise, profitable operations, and a sound capital base. Just as important, we have a team that has shown determination and ability in withstanding a challenging economic cycle, serving customers' needs, and producing growing value for shareholders.

We appreciate the commitment to excellence of our employees, the guidance of our Board of Directors, and the support of our shareholders, and we look forward to delivering many more years of progress in the future.

Sincerely,

GREGORY K. CLEVELAND
President and Chief Executive Officer

BNCCORP, INC.
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December 31, 2012
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Selected Financial Data

The selected consolidated financial data presented below should be read in conjunction with our consolidated financial statements and the notes thereto (dollars in thousands, except share and per share data):

	For the Years Ended December 31,				
	2012	2011	2010	2009	2008
Income Statement Data from Continuing Operations:					
Total interest income	\$ 23,992	\$ 25,749	\$ 33,510	\$ 44,588	\$ 46,026
Total interest expense	5,521	6,272	10,238	14,899	19,215
Net interest income	18,471	19,477	23,272	29,689	26,811
Provision for credit losses	100	1,625	5,750	27,000	7,750
Non-interest income	42,938	20,237	23,973	16,013	10,395
Fraud loss on assets serviced by others	-	-	26,231	-	-
Non-interest expense, excluding fraud loss on assets serviced by others	39,965	33,859	37,257	39,103	26,501
Income tax expense (benefit)	(5,280)	22	72	(1,625)	737
Net income (loss)	\$ 26,624	\$ 4,208	\$ (22,065)	\$ (18,776)	\$ 2,218
Preferred stock costs	(1,462)	(1,394)	(1,333)	(1,254)	-
Net income (loss) available to common shareholders	\$ 25,162	\$ 2,814	\$ (23,398)	\$ (20,030)	\$ 2,218
Balance Sheet Data: (at end of period)					
Total assets	\$ 770,776	\$ 665,158	\$ 747,069	\$ 868,083	\$ 861,498
Investments securities available for sale	300,549	242,630	137,032	212,661	209,857
Federal Reserve Bank and Federal Home Loan Bank stock	2,601	2,750	2,862	3,048	5,989
Loans held for sale-mortgage banking	95,095	68,622	29,116	24,130	13,403
Loans and leases held for investment, net of unearned income	289,469	293,211	350,501	517,108	542,753
Other loans held for sale, net	-	-	70,501	-	-
Allowance for credit losses	(10,091)	(10,630)	(14,765)	(18,047)	(8,751)
Deposits held for sale	-	-	107,446	-	-
Total deposits	649,604	576,255	661,111	755,963	675,321
Core deposits	584,604	516,436	594,152	640,169	575,637
Short-term borrowings	11,700	8,635	16,329	10,190	16,844
Federal Home Loan Bank advances	-	-	-	15,000	84,500
Guaranteed preferred beneficial interests in Company's subordinated debentures	22,430	22,427	24,134	22,890	23,025
Preferred stockholders' equity	20,888	20,687	20,486	20,285	-
Common stockholders' equity	47,842	21,180	16,835	36,980	53,947
Book value per common share outstanding	\$ 14.49	\$ 6.42	\$ 5.09	\$ 11.24	\$ 16.35
Tangible book value	\$ 14.49	\$ 6.42	\$ 5.09	\$ 11.24	\$ 16.23
Earnings Performance / Share Data from Continuing Operations:					
Return (loss) on average total assets	3.74	0.61%	(2.79)%	(2.09)%	0.28%
Return (loss) on average common stockholders' equity	76.77	15.77%	(90.47)%	(38.88)%	3.85%
Efficiency ratio	65.08%	85.26%	134.38%	85.56%	71.22%
Net interest margin	2.85%	3.11%	3.20%	3.58%	3.64%
Net interest spread	2.63%	2.89%	2.95%	3.37%	3.35%
Basic earnings (loss) per common share	\$ 7.64	\$ 0.86	\$ (7.13)	\$ (6.14)	\$ 0.67
Diluted earnings (loss) per common share	\$ 7.52	\$ 0.86	\$ (7.13)	\$ (6.14)	\$ 0.67
Average common shares outstanding	3,294,562	3,282,182	3,281,719	3,261,831	3,291,697
Average common and common equivalent shares	3,344,280	3,282,182	3,281,719	3,273,722	3,319,225
Shares outstanding at year end	3,300,652	3,301,007	3,304,339	3,290,219	3,299,163
Other Key Ratios					
Nonperforming assets to total assets	2.03%	2.45%	4.09%	4.97%	3.84%
Nonperforming loans to total assets	1.36%	0.93%	2.39%	4.13%	2.66%
Nonperforming loans to loans and leases held for investment	3.63%	2.10%	5.10%	6.94%	4.22%
Net loan charge-offs to average loans and leases held for investment	(0.225)%	(1.780)%	(1.530)%	(3.235)%	(1.066)%
Allowance for credit losses to total loans	2.62%	2.94%	3.84%	3.11%	1.50%
Allowance for credit losses to total nonperforming loans	96%	172%	83%	50%	38%

Quarterly Financial Data

	2012				
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	YTD
Interest income	\$ 6,131	\$ 5,904	\$ 6,095	\$ 5,862	\$ 23,992
Interest expense	1,486	1,505	1,328	1,202	5,521
Net interest income	4,645	4,399	4,767	4,660	18,471
Provision for credit losses	100	-	-	-	100
Net interest income after provision for credit losses	4,545	4,399	4,767	4,660	18,371
Non-interest income	5,697	10,753	16,826	9,662	42,938
Non-interest expense	8,672	10,021	12,303	8,969	39,965
Income before income taxes	1,570	5,131	9,290	5,353	21,344
Income tax expense (benefit)	2	101	(5,755)	372	(5,280)
NET INCOME	\$ 1,568	\$ 5,030	\$ 15,045	\$ 4,981	\$ 26,624
Preferred stock costs	(358)	(362)	(369)	(373)	(1,462)
Net income available to common shareholders	\$ 1,210	\$ 4,668	\$ 14,676	\$ 4,608	\$ 25,162
Basic earnings per common share	\$ 0.37	\$ 1.42	\$ 4.46	\$ 1.40	\$ 7.64
Diluted earnings per common share	\$ 0.37	\$ 1.42	\$ 4.41	\$ 1.34	\$ 7.52
Average common shares:					
Basic	3,291,907	3,291,907	3,291,569	3,294,562	3,294,562
Diluted	3,312,205	3,295,247	3,329,105	3,441,881	3,344,280

	2011				
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	YTD
Interest income	\$ 6,907	\$ 6,256	\$ 6,199	\$ 6,387	\$ 25,749
Interest expense	1,747	1,560	1,587	1,378	6,272
Net interest income	5,160	4,696	4,612	5,009	19,477
Provision for credit losses	600	500	275	250	1,625
Net interest income after provision for credit losses	4,560	4,196	4,337	4,759	17,852
Non-interest income	4,036	4,717	6,074	5,410	20,237
Non-interest expense	8,023	8,262	8,819	8,755	33,859
Income before income taxes	573	651	1,592	1,414	4,230
Income tax expense (benefit)	-	2	(2)	22	22
NET INCOME	\$ 573	\$ 649	\$ 1,594	\$ 1,392	\$ 4,208
Preferred stock costs	(339)	(345)	(354)	(356)	(1,394)
Net income available to common shareholders	<u>\$ 234</u>	<u>\$ 304</u>	<u>\$ 1,240</u>	<u>\$ 1,036</u>	<u>\$ 2,814</u>
Basic earnings per common share	<u>\$ 0.07</u>	<u>\$ 0.09</u>	<u>\$ 0.38</u>	<u>\$ 0.31</u>	<u>\$ 0.86</u>
Diluted earnings per common share	<u>\$ 0.07</u>	<u>\$ 0.09</u>	<u>\$ 0.38</u>	<u>\$ 0.31</u>	<u>\$ 0.86</u>
Average common shares:					
Basic	3,283,839	3,282,426	3,289,756	3,289,756	3,282,182
Diluted	3,283,839	3,282,426	3,289,756	3,289,756	3,282,182

Business

General

BNCCORP, INC. (BNCCORP or the Company) is a bank holding company headquartered in Bismarck, North Dakota. It is the parent company of BNC National Bank (the Bank). The Company operates community banking and wealth management businesses in North Dakota, Minnesota and Arizona from 14 locations. The Company also conducts mortgage banking from 12 locations in Arizona, Minnesota, Illinois, Kansas, Nebraska and Missouri.

Operating Strategy

We are a community bank that focuses on business banking. Our primary strategy is to build value for shareholders by providing relationship-based financial services to small and mid-sized businesses, business owners, their employees and professionals. The key elements of our strategy include:

- *Providing individualized, high-level customer service.* A significant portion of our strategic focus centers around our dedication to providing the highest level of customer service and establishing and maintaining long-term relationships. We believe that many of our competitors have emphasized retail banking and financial services for large companies, leaving the small and mid-sized business market underserved. Our consistent focus on the needs of such small and mid-sized businesses, as well as the individuals associated with them, has allowed us to compete effectively in this market segment.
- *Diversification of products and services.* We offer a wide variety of traditional and nontraditional financial products and services in order to meet the financial needs of our customer base, establish new relationships in the markets we serve and expand our business opportunities. We also seek to leverage our existing relationships with our banking clients by cross-selling our products and services, as well as offering relationship pricing to those clients who utilize a multitude of our products and services. We will continue to capitalize on the opportunities presented in the mortgage origination arena.
- *Expand opportunistically.* Our strategy involves growing our banking businesses within the markets that we serve and expanding into other attractive markets. Our strategy also includes offering a broad array of personal financial products and services to high net worth individuals and senior managers of the businesses with which we have established relationships. Our current strategies include a focus on expansion in North Dakota where we believe the demand for our services is particularly strong due to increased demand generated by the oil and gas and agricultural industries and generally favorable economic conditions. In Arizona, we will continue to grow organically focusing on small businesses and the SBA arena.
- *Managing credit risk.* We adhere to a uniform set of credit standards that are designed to ensure proper management of credit risk throughout our organization. Because we centrally administer our loan policies, we have been able to efficiently and continually monitor our loans and the loan review process despite our growth within the markets that we serve and our expansion into new markets. We focus on relationship building to grow loans.
- *Emphasize deposit growth.* We emphasize growing low-cost core deposits as a key strategy. Federal depository insurance can offer a strategic advantage to banks because it permits them to attract funds at a low cost. Historically, we have utilized this advantage to attract stable low cost deposits in each of our banking markets. We routinely conduct market surveys to compare our cost of deposits to competitors and attempt to price slightly below market. We believe our commitment to high customer service facilitates this approach.

In recent years, we have expanded our mortgage banking operations. The mortgage banking business can be strategically counter cyclical to community banking. For example, low interest rates and government support for the housing industry has provided favorable conditions for mortgage banking and, as a result, it has made significant contributions to earnings in recent periods. The continuation of these recent favorable mortgage banking conditions is subject to uncertainty.

Management's Discussion and Analysis of Financial Condition and Results of Operations

Overview

The following table summarizes selected income statement data and earnings per share data (in thousands, except per share data):

	<u>2012</u>	<u>2011</u>
<u>SELECTED INCOME STATEMENT DATA</u>		
Interest income	\$ 23,992	\$ 25,749
Interest expense	5,521	6,272
Net interest income	18,471	19,477
Provision for credit losses	100	1,625
Non-interest income	42,938	20,237
Non-interest expense	39,965	33,859
Income before income taxes	21,344	4,230
Income tax expense (benefit)	(5,280)	22
Net income	26,624	4,208
Preferred stock costs	(1,462)	(1,394)
Net income available to common shareholders	<u>\$ 25,162</u>	<u>\$ 2,814</u>
<u>EARNINGS PER SHARE DATA</u>		
Basic earnings per common share	\$ 7.64	\$ 0.86
Diluted earnings per common share	\$ 7.52	\$ 0.86

The following is an brief overview of recent periods:

- In 2012, the Company was exceptionally profitable. Results from core banking and mortgage banking operations in 2012 were enhanced by a non-recurring legal settlement and a non-recurring income tax benefit.
- Credit quality stabilized in 2012. In 2011, operations were characterized by lower non-performing assets, lower provisions for credit losses, and improved capital ratios at the Bank.
- Net interest income has been decreasing due to lower interest rates which have reduced the net interest margin. Our total assets have generally been declining since 2009, but this trend was partially reversed in 2012. For more information, see discussion of net interest income that follows in the MD&A.
- Non-interest income has been significantly impacted by gains on sales of loans and mortgage banking revenues. Decreasing interest rates have also facilitated realized and unrealized gains on investment securities. Non-interest income in 2012 includes \$7.5 million of income associated with a settlement with insurance carriers. For more information, see discussion of non-interest income that follows in the MD&A.
- Non-interest expense has been significantly impacted by higher volumes in mortgage banking and higher compensation as we have added and rewarded producers. In 2012, professional fees also included a contingent fee of \$2.5 million paid to our advisors when insurance litigation was settled. For more information, see discussion of non-interest expense that follows in the MD&A.
- In 2012, we recorded a significant tax benefit when the valuation allowance related to deferred tax assets was reversed. In future periods, tax expense is expected to be recognized at more normal effective rates.
- In early 2011, we sold certain loans, other assets and deposits in our Arizona and Minnesota markets to improve regulatory capital. Since then, regulatory capital ratios have steadily improved.
- In 2011 and 2012, we deferred payments on the Company's preferred stock and subordinated debentures as contractually permitted. We became current on these obligations in early 2013.

In recent years, the ratio of our common stockholders' equity to total assets has been low and the leverage at the holding company has been relatively high. In 2012, earnings have increased common equity, but management continues to assess the Company's capital structure.

General

Net income in 2012 was \$26.624 million, or \$7.52 per diluted share, compared to net income of \$4.208 million, or \$0.86 per diluted share in 2011.

Net Interest Income

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

	For the Year ended December 31, 2012			For the Year ended December 31, 2011			For the Year ended December 31, 2010		
	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
Assets									
Federal funds sold/interest-bearing due from	\$ 35,172	\$ 80	0.23%	\$ 63,570	\$ 161	0.25%	\$ 47,470	\$ 111	0.23%
Taxable investments	241,923	6,195	2.56%	204,463	7,606	3.72%	167,572	8,631	5.15%
Tax-exempt investments	31,096	967	3.11%	9,123	331	3.63%	2,111	93	4.41%
Participating interests in mortgage loans	-	-	0.00%	1,101	45	4.09%	20,144	665	3.30%
Loans held for sale-mortgage banking	66,288	2,263	3.41%	33,317	1,342	4.03%	29,039	1,263	4.35%
Loans and leases held for investment	284,507	14,487	5.09%	328,091	16,264	4.96%	478,492	22,747	4.75%
Allowance for credit losses	(10,560)	-	-	(12,754)	-	-	(17,201)	-	-
Total interest-earning assets	648,426	23,992	3.70%	626,911	25,749	4.11%	727,627	33,510	4.61%
Non-interest-earning assets:									
Cash and due from banks	11,155			8,997			9,929		
Other	51,597			53,360			53,146		
Total assets	<u>\$ 711,178</u>			<u>\$ 689,268</u>			<u>\$ 790,702</u>		
Liabilities and Stockholders' Equity									
Deposits:									
Interest checking and money market accounts	\$ 271,089	645	0.24%	\$ 253,054	940	0.37%	\$ 282,880	1,729	0.61%
Savings	15,549	16	0.10%	12,655	13	0.10%	11,156	11	0.10%
Certificates of deposit:									
Under \$100,000	127,446	2,368	1.86%	139,254	2,812	2.02%	186,978	5,426	2.90%
\$100,000 and over	65,563	828	1.26%	71,432	1,008	1.41%	99,141	1,642	1.66%
Total interest-bearing deposits	479,647	3,857	0.80%	476,395	4,773	1.00%	580,155	8,808	1.52%
Borrowings:									
Short-term borrowings	13,329	70	0.53%	15,583	132	0.85%	11,163	73	0.65%
FHLB advances	203	1	0.49%	11	-	0.00%	2,899	112	3.86%
Other borrowings	-	-	0.00%	-	-	0.00%	10	1	10.00%
Subordinated debentures	22,428	1,593	7.10%	23,437	1,367	5.83%	23,491	1,244	5.30%
Total interest-bearing liabilities	515,607	5,521	1.07%	515,426	6,272	1.22%	617,718	10,238	1.66%
Non-interest-bearing demand accounts	125,367	-	0.00%	124,208	-	0.00%	117,459	-	0.00%
Total deposits and interest-bearing liabilities	640,974			639,634			735,177		
Other non-interest-bearing liabilities	16,636			11,201			9,272		
Total liabilities	657,610			650,835			744,449		
Stockholders' equity	53,568			38,433			46,253		
Total liabilities and stockholders' equity	<u>\$ 711,178</u>			<u>\$ 689,268</u>			<u>\$ 790,702</u>		
Net interest income		<u>\$ 18,471</u>			<u>\$ 19,477</u>			<u>\$ 23,272</u>	
Net interest spread			<u>2.63%</u>			<u>2.89%</u>			<u>2.95%</u>
Net interest margin			<u>2.85%</u>			<u>3.11%</u>			<u>3.20%</u>
Ratio of average interest-earning assets to average interest-bearing liabilities	<u>125.76%</u>			<u>121.63%</u>			<u>117.79%</u>		

The following table allocates changes in our interest income and interest expense between the changes related to volume and rates (in thousands):

	For the Years Ended December 31, 2012 Compared to 2011			For the Years Ended December 31, 2011 Compared to 2010		
	Change Due to		Total	Change Due to		Total
	Volume	Rate		Volume	Rate	
Interest Earned on Interest-Earning Assets						
Federal funds sold/interest-bearing due from	\$ (66)	\$ (15)	\$ (81)	\$ 40	\$ 10	\$ 50
Taxable investments	1,233	(2,644)	(1,411)	1,667	(2,692)	(1,025)
Tax-exempt investments	690	(54)	636	257	(19)	238
Participating interests in mortgage loans	(23)	(23)	(46)	(748)	128	(620)
Loans held for sale- mortgage banking	1,153	(232)	921	177	(98)	79
Loans held for investment	(2,208)	432	(1,776)	(7,419)	936	(6,483)
Total increase (decrease) in interest income	<u>779</u>	<u>(2,536)</u>	<u>(1,757)</u>	<u>(6,026)</u>	<u>(1,735)</u>	<u>(7,761)</u>
Interest Expense on Interest-Bearing Liabilities						
Interest checking and money market accounts	63	(358)	(295)	(167)	(622)	(789)
Savings	3	-	3	2	-	2
Certificates of Deposit:						
Under \$100,000	(229)	(215)	(444)	(1,193)	(1,421)	(2,614)
\$100,000 and over	(79)	(101)	(180)	(415)	(219)	(634)
Short-term borrowings	(17)	(45)	(62)	34	25	59
FHLB advances	-	1	1	(56)	(56)	(112)
Other borrowings	-	-	-	-	(1)	(1)
Subordinated debentures	-	226	226	(3)	126	123
Total increase (decrease) in interest expense	<u>(259)</u>	<u>(492)</u>	<u>(751)</u>	<u>(1,798)</u>	<u>(2,168)</u>	<u>(3,966)</u>
Increase (decrease) in net interest income	<u>\$ 1,038</u>	<u>\$ (2,044)</u>	<u>\$ (1,006)</u>	<u>\$ (4,228)</u>	<u>\$ 433</u>	<u>\$ (3,795)</u>

Net interest income was \$18.471 million in 2012 compared to \$19.477 million in 2011, a decrease of \$1.006 million or 5.2%. The net interest margin decreased to 2.85% for the year ended December 31, 2012 from 3.11% in 2011.

In 2012, net interest income was lower as the impact of lower interest rates more than offset the impact of higher balances of assets and liabilities. Interest expense in 2012 included \$546 thousand of costs incurred when we exercised call options on \$60 million of brokered deposits to replace them with lower cost deposits. Our ability to lower our cost of funds in the future may be limited because interest rates are currently historically low. In 2012, earning assets increased as loans held for sale in mortgage banking operations and investments available for sale increased when we deployed funds from new deposits and liquidity built in prior periods. As 2012 progressed, we increased commercial lending, particularly in North Dakota.

Net interest income was \$19.477 million in 2011 compared to \$23.272 million in 2010, a decrease of \$3.795 million or 16.3%. The net interest margin decreased to 3.11% for the year ended December 31, 2011, from 3.20% in 2010.

In 2011, lower balances of assets and liabilities combined to reduce net interest income. Earning assets and interest bearing liabilities decreased in 2011 due to the sale of loans described in Note 3 of our Consolidated Financial Statements. We also stopped buying participating interests. Investments increased as we deployed liquidity built up in prior periods. In 2011, we were able to reduce interest expense more than interest income was impacted by the low rate environment.

Non-interest Income

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

	For the Years Ended December 31,		Increase (Decrease)	
	2012	2011	2012 – 2011	
			\$	%
Bank charges and service fees	\$ 2,492	\$ 2,218	\$ 274	12 % (a)
Wealth management revenues	1,204	1,282	(78)	(6) %
Mortgage banking revenues	29,658	11,285	18,373	163 % (b)
Gains on sales of loans, net	1,110	1,427	(317)	(22) % (c)
Gains on sales of securities, net	279	2,830	(2,551)	(90) % (d)
Insurance claim settlement	7,500	-	7,500	100 % (e)
Other	695	1,195	(500)	(42) % (f)
Total non-interest income	\$ 42,938	\$ 20,237	\$ 22,701	112 %

- (a) Bank charges and service fees increased in 2012 primarily due to growth in new accounts.
- (b) Mortgage banking revenues have been significant in recent years due to low interest rates and governmental support for the housing market. In the near term, we expect mortgage banking revenues to be elevated. Over the longer term, mortgage banking revenues may not be sustained at current levels as interest rates will inevitably rise.
- (c) In recent years, we have been selling SBA loans at gains as the secondary market is currently acquisitive and the loans can be sold for attractive prices. While sales of loans can vary significantly, we currently anticipate sales of SBA loans to continue for the foreseeable future.
- (d) Gains on sales of securities, net vary depending on the nature and volume of transactions.
- (e) In 2012, we recognized \$7.5 million of revenue associated with settlement of our claims against insurers related to a fraud that was perpetrated upon us during 2010.
- (f) In 2011, we received a distribution of \$300 thousand from an investment in a SBIC fund.

Non-interest Expense

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

	For the Years Ended December 31,		Increase (Decrease)	
	2012	2011	2012– 2011	
			\$	%
Salaries and employee benefits	\$ 17,040	\$ 14,972	\$ 2,068	14 % (a)
Professional services	7,165	4,307	2,858	66 % (b)
Data processing fees	2,859	2,673	186	7 %
Marketing and promotion	2,089	1,559	530	34 % (c)
Occupancy	1,935	2,028	(93)	(5) %
Regulatory costs	1,213	1,742	(529)	(30) % (d)
Depreciation and amortization	1,120	1,172	(52)	(4) %
Office supplies and postage	684	590	94	16 %
Other real estate costs	2,038	2,295	(257)	(11) % (e)
Other	3,822	2,521	1,301	52 % (f)
Total non-interest expense	\$ 39,965	\$ 33,859	\$ 6,106	18 %
Efficiency ratio	65.08%	85.26%	(20.18)%	

- (a) Compensation costs have increased due to higher volume in mortgage banking, additional mortgage banking and banking professionals and incentives accrued for producers. Wages in the North Dakota market are impacted by competitive pressures.
- (b) Professional services have been elevated due to the costs incurred to investigate and litigate the fraud loss discussed in Note 4 of our Consolidated Financial Statements. In 2012, professional fees include \$2.5 million of contingent fees paid when insurance litigation was settled. Higher volumes in mortgage banking operations also impacted professional fees.
- (c) In 2012, marketing and promotion costs increased in our mortgage banking operations.
- (d) Regulatory costs related to FDIC insurance decreased due to lower deposit balances after the divestiture discussed in Note 3 of our Consolidated Financial Statements.
- (e) Other real estate costs will vary depending on the level of foreclosed assets and valuation allowances recorded to reduce the carrying value of foreclosed properties.
- (f) Other expenses increased due to increases in the cost of carrying insurance and a non-recurring write off previously deferred costs associated with a capital offering.

Income Tax Expense (Benefit)

The Company has recognized a tax benefit of \$5.280 million in 2012, resulting primarily from the reversal of virtually all of our valuation allowance on deferred tax assets. The valuation allowance was reversed because we had achieved several consecutive profitable periods and the likelihood that future pre-tax earnings will utilize the remaining deferred tax assets. The tax benefit recorded by reversing the valuation allowance was reduced by estimated income tax expense related to 2012 earnings. Tax expense was \$22 thousand in 2011.

Financial Condition

Assets

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

	As of December 31,		Increase (Decrease)	
	2012	2011	2012 – 2011	
	\$	\$	\$	%
Cash and cash equivalents	\$ 40,790	\$ 19,296	\$ 21,494	111 % (a)
Investment securities available for sale	300,549	242,630	57,919	24 % (b)
Federal Reserve Bank and Federal Home Loan Bank of Des Moines stock	2,601	2,750	(149)	(5) % (c)
Loans held for sale-mortgage banking	95,095	68,622	26,473	39 % (d)
Loans and leases held for investment, net	279,378	282,581	(3,203)	(1) % (e)
Other real estate, net	5,131	10,145	(5,014)	(49) % (f)
Premises and equipment, net	15,932	16,035	(103)	(1) %
Interest receivable	2,590	2,411	179	7 %
Other assets	28,710	20,688	8,022	39 % (g)
Total assets	\$ 770,776	\$ 665,158	\$ 105,618	16 %

(a) Cash balances can vary significantly on a daily basis, but we tend to favor higher liquidity.

(b) Investments have increased as we have been emphasizing liquidity in recent years.

(c) Investments in these stocks are mandated by third parties.

(d) Mortgage banking loans held for sale have increased due to higher volume of originations in these operations.

(e) In recent years, loans held for investment have decreased as we have attempted to manage credit risk by reducing exposure. In later 2012, we began to re-emphasize commercial lending, particularly in North Dakota.

(f) Other real estate decreased as reducing problem assets has been an area of focus in recent years. See Note 10 of our Consolidated Financial Statements.

(g) Other assets have increased due to the balances of derivatives related to our mortgage banking operations. See Note 18 of our Consolidated Financial Statements.

Investment Securities Available for Sale

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

	December 31,			
	2012		2011	
	Amortized cost	Estimated fair market value	Amortized cost	Estimated fair market value
U.S. government agency mortgage-backed securities guaranteed by GNMA	\$ 60,673	\$ 63,587	\$ 57,912	\$ 59,300
U.S. government agency mortgage-backed securities issued by FNMA	20,727	20,608	6,004	6,171
U.S. government agency small business administration pools guaranteed by SBA	13,498	13,554	-	-
Collateralized mortgage obligations guaranteed by GNMA/VA	122,404	123,015	127,551	127,547
Collateralized mortgage obligations issued by FNMA or FHLMC	36,167	36,411	13,169	13,321
Other collateralized mortgage obligations	4,656	4,803	11,179	11,487
State and municipal bonds	35,944	38,571	22,670	24,804
Total investments	<u>\$ 294,069</u>	<u>\$ 300,549</u>	<u>\$ 238,485</u>	<u>\$ 242,630</u>

There were no securities that management concluded were other-than-temporarily impaired during 2012 or 2011. See Note 6 of our Consolidated Financial Statements.

The following table presents contractual maturities for securities available for sale and yields thereon at December 31, 2012 (dollars are in thousands):

	Within 1 year		After 1 but within 5 years		After 5 but within 10 years		After 10 years		Total	
	Amount	Yield ⁽¹⁾	Amount	Yield ⁽¹⁾	Amount	Yield ⁽¹⁾	Amount	Yield ⁽¹⁾	Amount	Yield ⁽¹⁾
U.S. government agency mortgage-backed securities guaranteed by GNMA ⁽²⁾⁽³⁾	\$ -	0.00%	\$ 141	6.56%	\$ 30	8.53%	\$ 60,502	2.38%	\$ 60,673	2.39%
U.S. government agency mortgage-backed securities issued by FNMA ⁽²⁾⁽³⁾	-	0.00%	-	0.00%	-	0.00%	20,727	2.10%	20,727	2.10%
U.S. government agency small business administration pools guaranteed by SBA ⁽²⁾⁽³⁾	-	0.00%	-	0.00%	-	0.00%	13,498	2.34%	13,498	2.34%
Collateralized mortgage obligations guaranteed by GNMA/VA ⁽²⁾⁽³⁾	-	0.00%	-	0.00%	10,525	1.46%	111,879	1.90%	122,404	1.86%
Collateralized mortgage obligations issued by FNMA or FHLMC ⁽²⁾⁽³⁾	-	0.00%	-	0.00%	554	6.15%	35,614	1.17%	36,168	1.25%
Other collateralized mortgage obligations ⁽²⁾⁽³⁾	-	0.00%	-	0.00%	-	0.00%	4,656	5.70%	4,656	5.70%
State and municipal bonds ⁽²⁾	-	0.00%	-	0.00%	2,108	8.05%	33,835	4.57%	35,943	4.77%
Total book value of investment securities	<u>\$ -</u>	<u>0.00%</u>	<u>\$ 141</u>	<u>0.00%</u>	<u>\$ 13,217</u>		<u>\$ 280,711</u>		<u>\$ 294,069</u>	<u>2.35%</u>
Unrealized gain on securities available for sale									6,480	
Total investment in securities available for sale									<u>\$ 300,549</u>	<u>2.30%</u>

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

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

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

As of December 31, 2012, we had \$300.5 million of available-for-sale securities in the investment portfolio compared to \$242.6 million at December 31, 2011.

In 2012, investment securities increased as we have deployed funds from new deposits and emphasized liquidity. Net unrealized gains increased as of December 31, 2012 as compared to December 31, 2011 due to the decline in market interest rates and shorter remaining lives of investments.

In 2011, investment securities increased as cash balances built up in prior periods was invested in order to increase income from earning assets. Net unrealized gains increased as of December 31, 2011 as compared to December 31, 2010 due to the general decline in market interest rates. During 2011, we realized \$2.830 million of net gains on sales of securities. While these gains can vary from period to period, we capitalized on conditions that had been increasing the value of mortgage based investment portfolios.

At December 31, 2012, we held no securities, other than U.S. Government Agency mortgage-backed securities and collateralized mortgage obligations, that exceeded 10% of stockholders' equity. A portion of our investment securities portfolio was pledged as collateral.

See Note 6 of our Consolidated Financial Statements for more information about investment securities.

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

Our equity securities consisted of \$1.8 million of Federal Reserve Bank ("FRB") stock as of December 31, 2012 and 2011, and \$795 thousand and \$1.0 million of FHLB of Des Moines stock as of December 31, 2012 and 2011, respectively.

Loans

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

	2012		2011		2010		2009		2008	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Loans held for sale- mortgage banking	\$ 95,095	100.0	\$ 68,622	100.0	\$ 29,116	29.2	\$ 24,130	100.0	\$ 13,403	100.0
Other loans held for sale	-	-	-	-	70,501	70.8	-	-	-	-
Loans held for sale, net	<u>95,095</u>	<u>100.0</u>	<u>68,622</u>	<u>100.0</u>	<u>99,617</u>	<u>100.0</u>	<u>24,130</u>	<u>100.0</u>	<u>13,403</u>	<u>100.0</u>
Commercial and industrial	116,891	40.4	109,746	37.4	120,620	34.4	225,470	43.6	243,823	44.9
Commercial real estate	87,258	30.1	115,704	39.4	152,287	43.4	152,194	29.4	142,586	26.3
SBA	15,823	5.5	9,958	3.4	11,064	3.2	9,260	1.8	10,555	1.9
Consumer	26,614	9.2	23,038	7.9	25,841	7.4	34,439	6.7	39,089	7.2
Land and land development	31,065	10.7	29,350	10.0	37,761	10.8	73,530	14.2	70,783	13.1
Construction	11,814	4.1	5,545	1.9	3,225	0.9	22,797	4.4	36,724	6.7
	<u>289,465</u>	<u>100.0</u>	<u>293,341</u>	<u>100.0</u>	<u>350,798</u>	<u>100.1</u>	<u>517,690</u>	<u>100.1</u>	<u>543,560</u>	<u>100.1</u>
Unearned income and net unamortized deferred (fees) and costs	<u>4</u>	<u>-</u>	<u>(130)</u>	<u>-</u>	<u>(297)</u>	<u>(0.1)</u>	<u>(582)</u>	<u>(0.1)</u>	<u>(807)</u>	<u>(0.1)</u>
Loans, net of unearned income and unamortized fees and costs	<u>\$ 289,469</u>	<u>100.0</u>	<u>\$ 293,211</u>	<u>100.0</u>	<u>\$ 350,501</u>	<u>100.0</u>	<u>\$ 517,108</u>	<u>100.0</u>	<u>\$ 542,753</u>	<u>100.0</u>

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

	December 31,		Increase (Decrease)	
	2012	2011	2012 - 2011	
	\$	\$	\$	%
Loans held for sale-mortgage banking	<u>\$ 95,095</u>	<u>\$ 68,622</u>	<u>\$ 26,473</u>	38.6 % (a)
Commercial and industrial	116,891	109,746	7,145	6.5 % (b)
Commercial real estate	87,258	115,704	(28,446)	(24.6) % (b)
SBA	15,823	9,958	5,865	58.9 %
Consumer	26,614	23,038	3,576	15.5 % (b)
Land and land development	31,065	29,350	1,715	5.8 % (b)
Construction	<u>11,814</u>	<u>5,545</u>	<u>6,269</u>	113.1 %
	<u>289,465</u>	<u>293,341</u>	<u>(3,876)</u>	(1.3) %
Unearned income and net unamortized deferred fees and costs	<u>4</u>	<u>(130)</u>	<u>134</u>	(103.1) %
Loans, net of unearned income and unamortized fees and costs	<u>\$ 289,469</u>	<u>\$ 293,211</u>	<u>\$ (3,742)</u>	(1.3) %

(a) Mortgage banking loans held for sale increased in 2012 as originations of mortgage banking loans have increased.

(b) Loan balances have generally decreased due to repayments, charge-offs and our efforts to reduce credit exposures. As 2012 progressed we increased commercial lending, particularly in North Dakota.

Loan Participations

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

Loan participations sold on a nonrecourse basis to outside financial institutions were as follows as of December 31 (in thousands):

2012	\$	218,068
2011		220,177
2010		259,939
2009		330,204
2008		315,469

Concentrations of Credit

The following table summarizes the location of our borrowers as of December 31 (dollars are in thousands):

	<u>2012</u>			<u>2011</u>		
North Dakota	\$	176,653	61 %	\$	157,622	54 %
Minnesota		38,188	13		61,089	21
Arizona		29,238	10		28,382	9
Other		45,386	16		46,248	16
Total gross loans held for investment	\$	<u>289,465</u>	<u>100 %</u>	\$	<u>293,341</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 as of December 31 (dollars are in thousands):

	2012		2011	
North Dakota	\$ 168,198	58%	\$ 147,275	50%
Arizona	40,215	14	32,902	11
California	22,088	8	23,092	8
Minnesota	17,561	6	20,718	7
Colorado	7,686	3	7,736	3
Wisconsin	6,489	2	6,765	2
Other	27,228	9	54,853	19
Total gross loans held for investment	\$ 289,465	100 %	\$ 293,341	100 %

The following table presents loans by type within our three primary states as of December 31 (in thousands):

	<u>2012</u>	<u>2011</u>
	Total Loans and Leases Held for Investment	Total Loans and Leases Held for Investment
North Dakota		
Commercial and industrial	\$ 65,793	\$ 65,986
Construction	10,824	2,533
Agricultural	15,047	13,043
Land and land development	12,240	10,579
Owner-occupied commercial real estate	24,107	25,526
Commercial real estate	12,644	12,100
Small business administration	2,428	2,333
Consumer	<u>25,115</u>	<u>15,175</u>
Subtotal	<u>\$ 168,198</u>	<u>\$ 147,275</u>
Arizona		
Commercial and industrial	\$ 1,421	\$ 2,552
Construction	-	-
Agricultural	-	-
Land and land development	5,663	5,832
Owner-occupied commercial real estate	667	550
Commercial real estate	16,699	14,070
Small business administration	12,881	7,085
Consumer	<u>2,884</u>	<u>2,813</u>
Subtotal	<u>\$ 40,215</u>	<u>\$ 32,902</u>
Minnesota		
Commercial and industrial	\$ 1,154	\$ 1,316
Construction	-	2,090
Agricultural	24	28
Land and land development	1,145	1,649
Owner-occupied commercial real estate	-	-
Commercial real estate	14,767	14,665
Small business administration	62	77
Consumer	<u>409</u>	<u>893</u>
Subtotal	<u>\$ 17,561</u>	<u>\$ 20,718</u>

Loan Maturities⁽¹⁾

The following table sets forth the remaining maturities of loans in our portfolio as of December 31, 2012 (in thousands):

	One year or less	Over 1 year through 5 years		Over 5 years		Total Loans and Leases Held for Investment
		Fixed rate	Floating rate	Fixed rate	Floating rate	
Commercial and industrial	\$ 42,930	\$ 41,673	\$ 11,335	\$ 16,315	\$ 4,638	\$ 116,891
Commercial real estate	40,714	16,320	17,898	9,017	3,309	87,258
SBA	912	151	1,155	1,966	11,639	15,823
Consumer	2,720	14,779	3,727	5,175	213	26,614
Land and land development	6,447	4,280	15,546	1,091	3,701	31,065
Construction	1,549	-	79	6,932	3,254	11,814
Total principal amount of loans	<u>\$ 95,272</u>	<u>\$ 77,203</u>	<u>\$ 49,740</u>	<u>\$ 40,496</u>	<u>\$ 26,754</u>	<u>\$ 289,465</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 substantially the same manner as new credit applications.

Provision for Credit Losses

In recent periods, challenging macroeconomic forces have impaired the ability of borrowers to repay debt which resulted in higher credit losses throughout the financial industry.

We provide for credit losses to maintain our allowance for credit losses at a level adequate to cover estimated probable losses inherent in the portfolio as of each balance sheet date. The provision for credit losses for the year ended December 31, 2012 was \$100 thousand as compared to \$1.625 million in 2011. The provision for credit losses decreased in 2012 as credit quality stabilized.

Allowance for Credit Losses

See Notes 1 and 9 of our Consolidated Financial Statements and “Critical Accounting Policies” for further information concerning accounting policies associated with the allowance for credit losses.

The following table summarizes activity in the allowance for credit losses and certain ratios (dollars are in thousands):

Analysis of Allowance for Credit Losses

	For the Years ended December 31,				
	2012	2011	2010	2009	2008
Balance of allowance for credit losses, beginning of period	\$ 10,630	\$ 14,765	\$ 18,047	\$ 8,751	\$ 6,599
Charge-offs:					
Commercial and industrial	(70)	(83)	(3,112)	(6,408)	(739)
Commercial real estate	(767)	(4,549)	(283)	(1,993)	(219)
SBA	(10)	(105)	(620)	-	-
Consumer	(58)	(1,049)	(533)	(394)	(459)
Land and land development	-	(731)	(3,238)	(9,081)	(4,529)
Construction	-	-	-	-	-
Total charge-offs	(905)	(6,517)	(7,786)	(17,876)	(5,946)
Recoveries:					
Commercial and industrial	11	49	14	12	84
Commercial real estate	38	506	-	-	-
SBA	12	21	5	-	-
Consumer	18	34	319	11	68
Land and land development	187	67	127	149	196
Construction	-	-	-	-	-
Total recoveries	266	677	465	172	348
Net charge-offs	(639)	(5,840)	(7,321)	(17,704)	(5,598)
Provision for credit losses charged to operations	100	1,625	5,750	27,000	7,750
	10,091	10,550	16,476	18,047	8,751
Transferred (to) from other loans held for sale	-	80	(1,711)	-	-
Balance of allowance for credit losses, end of period	\$ 10,091	\$ 10,630	\$ 14,765	\$ 18,047	\$ 8,751
Ratio of net charge-offs to average total loans	(0.182)%	(1.611)%	(1.387)%	(2.948)%	(0.507)%
Ratio of net charge-offs to average loans and leases held for investment	(0.225)%	(1.780)%	(1.530)%	(3.235)%	(0.534)%
Average gross loans and leases held for investment	\$ 284,507	\$ 328,091	\$ 478,492	\$ 547,336	\$ 525,311
Ratio of allowance for credit losses to loans and leases held for investment	3.49%	3.63%	4.21%	3.49%	1.61%
Ratio of allowance for credit losses to total nonperforming loans	96%	172%	83%	50%	38%
Allowance for credit losses to total loans	2.62%	2.94%	3.84%	3.11%	1.50%
Ratio of nonperforming loans to total assets	1.36%	0.93%	2.39%	4.13%	2.66%

For several years, the allowance for credit losses has been elevated in recent periods because of an increase in nonperforming assets and deteriorating economic conditions.

In 2012, the level of nonperforming loans stabilized. At December 31, 2012, nonperforming loans included one loan with a balance of approximately \$5.8 million that is involved with bankruptcy proceedings. We are well collateralized and remain optimistic the courts will ultimately award full recovery.

The table below presents 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 as of December 31 (dollars are in thousands).

Allocation of the Allowance for Loan Losses

	2012		2011		2010		2009		2008	
	Total Loans and Leases Held for Investment Allowance	Loans in Category as a Percentage of Total Gross Loans and Leases Held for Investment	Total Loans and Leases Held for Investment Allowance	Loans in Category as a Percentage of Total Gross Loans and Leases Held for Investment	Total Loans and Leases Held for Investment Allowance	Loans in Category as a Percentage of Total Gross Loans and Leases Held for Investment	Total Loans and Leases Held for Investment Allowance	Loans in Category as a Percentage of Total Gross Loans and Leases Held for Investment	Total Loans and Leases Held for Investment Allowance	Loans in Category as a Percentage of Total Gross Loans and Leases Held for Investment
Commercial and industrial	\$ 2,546	40%	\$ 1,639	37%	\$ 1,362	34%	\$ 7,440	44%	\$ 2,095	45%
Commercial real estate	4,790	30%	5,518	40%	9,818	44%	4,494	29%	1,281	26%
SBA	616	6%	436	3%	407	3%	260	2%	264	2%
Consumer	382	9%	448	8%	1,182	7%	1,162	7%	844	7%
Land and land development	1,609	11%	2,532	10%	1,939	11%	3,849	14%	3,564	13%
Construction	148	4%	57	2%	57	1%	842	4%	703	7%
Total	<u>\$ 10,091</u>	<u>100%</u>	<u>\$ 10,630</u>	<u>100%</u>	<u>\$ 14,765</u>	<u>100%</u>	<u>\$ 18,047</u>	<u>100%</u>	<u>\$ 8,751</u>	<u>100%</u>

The amount of the allowance for losses can vary depending on macroeconomic conditions and risk in the portfolio. The allocation of the allowance for losses can vary depending on relative volume of asset groups in the portfolio and risks therein.

Allowance for Credit Losses; Impact on Earnings

We have established the allowance for credit losses to cover for estimated losses inherent to the loans and lease portfolio at December 31, 2012 and December 31, 2011. The allowance for credit losses is an estimate based upon several judgmental factors. We are not aware of known trends, commitments or other events that could reasonably occur that would materially affect our methodology or the assumptions used to estimate the allowance for credit losses. However, changes in qualitative and quantitative factors could occur at any time and such changes could be of a material nature. In addition, economic situations change, financial conditions of borrowers morph and other factors we consider in arriving at our estimates may evolve. To the extent that these matters have negative developments, our future earnings could be reduced by high provisions for credit losses.

Nonperforming Loans and Assets

The following table sets forth nonperforming assets, the allowance for credit losses and certain related ratios (dollars are in thousands):

	As of December 31,				
	2012	2011	2010	2009	2008
Nonperforming loans:					
Loans 90 days or more delinquent and still accruing interest	\$ 12	\$ -	\$ -	\$ 1	\$ 6
Non-accrual loans	10,500	6,169	17,862	35,889	22,909
Total nonperforming loans	10,512	6,169	17,862	35,890	22,915
Other real estate, net	5,131	10,145	12,706	7,253	10,189
Total nonperforming assets	<u>\$ 15,643</u>	<u>\$ 16,314</u>	<u>\$ 30,568</u>	<u>\$ 43,143</u>	<u>\$ 33,104</u>
Allowance for credit losses	<u>\$ 10,091</u>	<u>\$ 10,630</u>	<u>\$ 14,765</u>	<u>\$ 18,047</u>	<u>\$ 8,751</u>
Ratio of total nonperforming loans to total loans	2.73%	1.70%	3.93%	6.19%	3.92%
Ratio of total nonperforming loans to loans and leases held for investment	3.63%	2.10%	5.10%	6.94%	4.22%
Ratio of total nonperforming assets to total assets	2.03%	2.45%	4.09%	4.97%	3.84%
Ratio of nonperforming loans to total assets	1.36%	0.93%	2.39%	4.13%	2.66%
Ratio of allowance for credit losses to total nonperforming loans	96%	172%	83%	50%	38%

Nonperforming Loans

The following table sets forth information concerning our nonperforming loans as of December 31 (in thousands):

	2012	2011
Balance, beginning of period	\$ 6,169	\$ 17,862
Additions to nonperforming	5,880	6,312
Charge-offs	(354)	(3,895)
Reclassified back to performing	(815)	(3,616)
Principal payments received	(368)	(4,442)
Transferred to other real estate	-	(6,052)
Balance, end of period	<u>\$ 10,512</u>	<u>\$ 6,169</u>

At December 31, 2012, nonperforming loans include one loan relationship with an aggregate balance of \$5.8 million which is currently in bankruptcy proceedings. We are well collateralized on this loan and remain optimistic the courts will ultimately award us full recovery.

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

	2012	2011
Interest income that would have been recorded	\$ 919	\$ 1,057
Interest income recorded	329	149
Effect on interest income	<u>\$ 590</u>	<u>\$ 908</u>

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 include loans on which the accrual of interest has been discontinued. Accrual of interest is discontinued when we believe 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. 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.

Troubled Debt Restructuring (TDR)

The table below summarizes the amounts of restructured loans as of December 31 (in thousands):

	<u>Total</u>	<u>Accrual</u>	<u>Non-accrual</u>
2012	\$ 12,368	\$ 7,871	\$ 4,497
2011	12,848	\$ 7,270	5,578
2010	34,264	18,482	15,782
2009	14,337	1,291	13,046
2008	2,379	-	2,379

See Note 9 of our Consolidated Financial Statements for information on troubled debt restructuring.

Other real estate owned and repossessed assets represent properties and other assets acquired through, or in lieu of, loan foreclosure. They are initially recorded at fair value less cost to sell at the date of acquisition establishing a new cost basis. Write-downs to fair value at the time of acquisition are charged to the allowance for credit losses. After foreclosure, we perform valuations periodically and the real estate is recorded at fair value less cost to sell. Reductions to other real estate owned and repossessed assets are considered valuation allowances. Expenses incurred to record valuation allowances subsequent to foreclosure are charged to non-interest expense.

See Note 10 of our Consolidated Financial Statements for information on other real estate owned.

Impaired loans

See Note 9 of our Consolidated Financial Statements for information on impaired loans.

Potential Problem Loans

In recent years, the macroeconomic environment is very challenging and asset values were declining throughout most of the country. So long as these conditions persist, many loans are potentially problematic assets.

Notwithstanding the prior paragraph, we attempt to quantify potential problem loans with more immediate credit risk. We estimate there are loans risk rated "watch list" which are not impaired aggregating \$5.2 million and \$5.0 million at December 31, 2012 and 2011, respectively. Also, we estimate there are loans risk rated "substandard" which are not impaired aggregating \$3.1 million and \$18.8 million at December 31, 2012 and 2011, respectively.

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

Liabilities and Stockholders' Equity

The following table presents our liabilities and stockholders' equity (dollars are in thousands):

	As of December 31,		Increase (Decrease)	
			2012 – 2011	
	2012	2011	\$	%
Deposits:				
Non-interest-bearing	\$ 131,593	\$ 116,864	\$ 14,729	13 % (a)
Interest-bearing-				
Savings, interest checking and money market	313,051	269,075	43,976	16 % (a)
Time deposits under \$100,000	128,150	128,255	(105)	- % (b)
Time deposits \$100,000 and over	76,810	62,061	14,749	24 % (b)
Short-term borrowings	11,700	8,635	3,065	35 % (c)
Guaranteed preferred beneficial interests in Company's subordinated debentures	22,430	22,427	3	- %
Accrued interest payable	5,045	3,609	1,436	40 % (d)
Accrued expenses	10,144	6,244	3,900	62 % (e)
Other liabilities	3,123	6,121	(2,998)	(49) % (f)
Total liabilities	702,046	623,291	78,755	13 %
Stockholders' equity	68,730	41,867	26,863	64 % (g)
Total liabilities and stockholders' equity	\$ 770,776	\$ 665,158	\$ 105,618	16 %

- (a) Economic conditions in North Dakota, our primary market, have been relatively robust. These types of accounts fluctuate daily due to the cash management activities of our customers. As a result, we have experienced growth.
- (b) These deposits increased due to growth. Economic conditions in North Dakota, our primary market, have been relatively robust.
- (c) Short-term borrowings are primarily customer repurchase agreements. These balances can vary significantly depending on customer preferences.
- (d) In 2010, we suspended payment of interest on our subordinated debt. At December 31, 2012 and 2011, respectively, approximately \$4.8 million and \$3.2 million of the balance relates to interest accrued but not paid. We made interest payments in early 2013 to get current on these obligations. See Note 17 of our Consolidated Financial Statements.
- (e) In 2010, we suspended payment on our dividends to preferred stockholders. At December 31, 2012 and 2011, respectively, approximately \$3.7 million and \$2.5 million of the balance relates to dividends accrued but not paid. We made a dividend payment in mid February 2013 to get current on the preferred stock. See Note 17 of our Consolidated Financial Statements. The remainder of the increase relates to a higher reserve for potential mortgage banking obligations (See Note 20 of our Consolidated Financial Statement), accounts payable, and accrued incentives for producers.
- (f) Other liabilities decreased \$2.1 million due to the decrease in the fair value of mortgage banking derivatives. See Note 19 of our Consolidated Financial Statements. The 2011 balance also included approximately \$900,000 of funds held in suspense until they could be applied.
- (g) The increase in stockholder equity relates primarily to earnings. Managing capital has been a focus of management in recent periods and this will continue in the future. Management will continue to evaluate the capital condition of the Company.

Mortgage Banking Obligations

Included in accrued expenses, is an estimate of mortgage banking reimbursement obligations which aggregated \$1.5 million and \$800,000 at December 31, 2012 and 2011, respectively. Although we sell mortgage banking loans without recourse, industry standards require standard representations and warranties which require sellers to reimburse investors for economic losses if loans default or prepay after the sale. To estimate the obligation, we track historical reimbursements and calculate the ratio of reimbursement to loan production volumes. Using reimbursement ratios and recent production levels, we estimate the future reimbursement amounts and record the estimated obligation.

Deposits

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

	For the Years Ended December 31,								
	2012			2011			2010		
	Average balance	Percent of deposits	Wgt'd. avg. rate	Average balance	Percent of deposits	Wgt'd. avg. rate	Average balance	Percent of deposits	Wgt'd. avg. rate
Interest checking and MMDAs	\$ 271,089	44.81%	0.24%	\$ 253,054	42.13%	0.37%	\$ 282,880	40.55%	0.61%
Savings deposits	15,549	2.57%	0.10%	12,655	2.11%	0.10%	11,156	1.60%	0.10%
Time deposits (CDs):									
CDs under \$100,000	127,446	21.06%	1.86%	139,254	23.19%	2.02%	186,978	26.80%	2.90%
CDs \$100,000 and over	65,563	10.84%	1.26%	71,432	11.89%	1.41%	99,141	14.21%	1.66%
Total time deposits	193,009	31.90%	1.66%	210,686	35.08%	1.81%	286,119	41.01%	2.47%
Total interest-bearing deposits	479,647	79.28%	0.80%	476,395	79.32%	1.00%	580,155	83.16%	1.52%
Non-interest-bearing demand deposits	125,367	20.72%	-	124,208	20.68%	-	117,459	16.84%	-
Total deposits	\$ 605,014	100.00%	0.64%	\$ 600,603	100.00%	0.79%	\$ 697,614	100.00%	1.26%

In 2010, we were attempting to reduce deposits to improve capital ratios either by selling the deposits or reducing rates paid. Since the middle of 2011, we have returned to growing deposits and throughout 2012 we have attempted to capitalize on economic growth in North Dakota.

Time deposits, in denominations of \$100,000 and over, totaled \$76.8 million at December 31, 2012 as compared to \$62.1 million at December 31, 2011. The following table sets forth the amount and maturities of time deposits of \$100,000 and over as of December 31, 2012 (in thousands):

Maturing in:

3 months or less	\$	29,548
Over 3 months through 6 months		8,730
Over 6 months through 12 months		21,609
Over 12 months		16,923
	\$	<u>76,810</u>

Borrowed Funds

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

	2012	2011	2010
Short-term borrowings outstanding at period end	\$ 11,700	\$ 8,635	\$ 16,329
Weighted average interest rate at period end	0.38%	0.92%	0.48%
Maximum month end balance during the period	\$ 16,949	\$ 21,165	\$ 16,329
Average borrowings outstanding for the period	\$ 13,329	\$ 15,583	\$ 11,163
Weighted average interest rate for the period	0.53%	0.85%	0.65%

Note 13 of our Consolidated Financial Statements summarizes the general terms of our short-term borrowings outstanding at December 31, 2012 and 2011.

FHLB advances totaled \$0 at December 31, 2012 and 2011, respectively.

Notes 14 and 15 of our Consolidated Financial Statements summarize the general terms of our FHLB advances and other borrowings at December 31, 2012 and 2011.

Guaranteed Preferred Beneficial Interests in Company's Subordinated Debentures

See Note 16 of our Consolidated Financial Statements for a description of the subordinated debentures.

Capital Resources and Expenditures

	<u>2012</u>	<u>2011</u>	<u>2010</u>	<u>2009</u>	<u>2008</u>
Tier 1 leverage (Consolidated)	11.17%	7.59%	6.17%	8.58%	9.01%
Tier 1 risk-based capital (Consolidated)	20.49%	13.71%	9.46%	12.32%	11.15%
Total risk-based capital (Consolidated)	22.43%	17.56%	12.89%	14.15%	12.95%
Tangible common equity (Consolidated)	6.21%	3.17%	2.24%	4.23%	6.21%
Tier 1 leverage (BNC National Bank)	10.68%	9.41%	7.53%	8.54%	9.34%
Tier 1 risk-based capital (BNC National Bank)	19.80%	16.95%	11.53%	12.25%	11.56%
Total risk-based capital (BNC National Bank)	21.06%	18.22%	12.80%	13.52%	12.81%

See Note 2 of our Consolidated Financial Statements for a discussion of regulatory capital and the current operating environment. Improving capital ratios has been a focus of management in recent years.

The Federal Reserve has recently issued a Notice of Proposed Rulemaking (NPR) which would significantly change regulatory capital calculations for community banks. The NPR would require community banks to incorporate provisions of the BASEL III framework when calculating regulatory capital. We have not completed our assessment of the NPR, but it is generally believed the proposed standards would impose higher capital requirements and impose significantly more complex calculations when deriving regulatory capital ratios. The NPR is currently subject to a comment period.

Off-Balance-Sheet Arrangements

In the normal course of business, we are a party to various financial instruments with off-balance-sheet risk. These instruments include commitments to extend credit, commercial letters of credit, performance and financial standby letters of credit and interest rate swaps, caps and floors. Such instruments help us to meet the needs of our customers, manage our interest rate risk and effectuate various transactions. These instruments and commitments, which we enter into for purposes other than trading, carry varying degrees of credit, interest rate or liquidity risk. See Notes 20 and 21 of our Consolidated Financial Statements for a detailed description of each of these instruments.

Contractual Obligations, Contingent Liabilities and Commitments

We are a party to financial instruments with risks that can be subdivided into two categories:

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

Credit-related financial instruments, generally characterized as off-balance-sheet items, include such instruments as commitments to extend credit, commercial letters of credit and performance and financial standby letters of credit. See Note 20 of our Consolidated Financial Statements.

At December 31, 2012, the aggregate contractual obligations (excluding bank deposits) and commitments were as follows (in thousands):

Contractual Obligations:	Payments due by period				
	Less than 1				
	year	1 to 3 years	3 to 5 years	After 5 years	Total
Total borrowings	\$ 11,700	\$ -	\$ -	\$ 22,430	\$ 34,130
Commitments to sell loans	92,271	-	-	-	92,271
Annual rental commitments under non-cancelable operating leases	720	887	710	1,536	3,853
Total	\$ 104,691	\$ 887	\$ 710	\$ 23,966	\$ 130,254

Other Commitments:	Amount of Commitment - Expiration by Period				
	Less than 1				
	year	1 to 3 years	3 to 5 years	After 5 years	Total
Commitments to lend	\$ 203,468	\$ 7,347	\$ 4,136	\$ 52	\$ 215,003
Standby and commercial letters of credit	736	724	-	-	1,460
Total	\$ 204,204	\$ 8,071	\$ 4,136	\$ 52	\$ 216,463

Liquidity Risk Management

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

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

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

We measure our liquidity position on an as needed basis, but no less frequently than monthly. We measure our liquidity position using the total of the following items:

1. Estimated liquid assets less estimated volatile liabilities using the aforementioned methodology (\$166.8 million as of December 31, 2012);
2. Borrowing capacity from the FHLB (\$47.9 million as of December 31, 2012); and
3. Capacity to issue brokered deposits with maturities of less than 12 months (\$102.8 million as of December 31, 2012).

On an on-going basis, we use a variety of factors to assess our liquidity position including, but not limited to, the following items:

- Stability of our deposit base,
- Amount of pledged investments,
- Amount of unpledged investments,
- Liquidity of our loan portfolio, and
- Potential loan demand.

Our liquidity assessment process segregates our balance sheet into liquid assets and short-term liabilities assumed to be vulnerable to non-replacement over a 30 day horizon in abnormally stringent conditions. Assumptions for the vulnerable short-term liabilities are based upon historical factors. We have a targeted range for our liquidity position over this horizon and manage operations to achieve these targets.

We further project cash flows over a 12 month horizon based on our assets and liabilities and sources and uses of funds for anticipated events.

Pursuant to our contingency funding plan, we also estimate cash flows over a 12 month horizon under a variety of stressed scenarios to identify potential funding needs and funding sources. Our contingency plan identifies actions that could be taken in response to adverse liquidity events.

We believe this process, combined with our policies and guidelines, should provide for adequate levels of liquidity to fund the anticipated needs of on- and off- balance sheet items.

Forward-Looking Statements

Statements included in “Management’s Discussion and Analysis of Financial Condition and Results of Operations” which are not historical in nature are intended to be, and are hereby identified as “forward-looking statements” for purposes of the safe harbor provided by Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. We caution readers that these forward-looking statements, including without limitation, those relating to our future business prospects, revenues, working capital, liquidity, capital needs, interest costs, income and expenses, are subject to certain risks and uncertainties that could cause actual results to differ materially from those indicated in the forward-looking statements due to several important factors. These factors include, but are not limited to: risks of loans and investments, including dependence on local and regional economic conditions; competition for our customers from other providers of financial services; possible adverse effects of changes in interest rates including the effects of such changes on derivative contracts and associated accounting consequences; risks associated with our acquisition and growth strategies; and other risks which are difficult to predict and many of which are beyond our control.

Recently Issued and Adopted Accounting Pronouncements

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

Critical Accounting Policies

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

Quantitative and Qualitative Disclosures About Market Risk

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

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

Our interest rate risk exposure is actively managed with the objective of managing the level and potential volatility of net interest income in addition to the long-term growth of equity, bearing in mind that we will always be in the business of taking on rate risk and that rate risk immunization is not entirely possible. Also, it is recognized that as exposure to interest rate risk is reduced, so too may the overall level of net interest income and equity. In general, the assets and liabilities generated through ordinary business activities do not naturally create offsetting positions with respect to repricing or maturity characteristics. Access to the derivatives market can be an important element in maintaining our interest rate risk position within policy guidelines. Using derivative instruments, principally interest rate floors, caps, and interest rate swaps, the interest rate sensitivity of specific transactions, as well as pools of assets or liabilities, can be adjusted to maintain the desired interest rate risk profile. See Note 1 of our Consolidated Financial Statements for a summary of our accounting policies pertaining to such instruments.

Our primary tool for measuring and managing interest rate risk is net interest income simulation. This exercise includes our assumptions regarding the changes in interest rates and the impact on our current balance sheet. Interest rate caps and floors are included to the extent that they are exercised in the 12-month simulation period.

Additionally, changes in prepayment behavior of the residential mortgage, CMOs, and mortgage-backed securities portfolios in each rate environment are captured using industry estimates of prepayment speeds for various coupon segments of the portfolio. For purposes of this simulation, projected month end balances of the various balance sheet accounts are held constant at their December 31, 2012 levels. Cash flows from a given account are reinvested back into the same account so as to keep the month end balance constant at its December 31, 2012 level. The static balance sheet assumption is made so as to project the interest rate risk to net interest income embedded in the existing balance sheet. With knowledge of the balance sheet's existing net interest income profile, more informed strategies and tactics may be developed as it relates to the structure/mix of growth.

We monitor the results of net interest income simulation on a regular basis. Net interest income is generally simulated for the upcoming 12-month horizon in seven interest rate scenarios. The scenarios generally modeled are parallel interest rate ramps of +/- 100bp, 200bp, and 300bp along with a rates unchanged scenario. Given the current low absolute level of interest rates as of December 31, 2012, the downward scenarios for interest rate movements is limited to -100bp but a +400bp scenario has been added. The parallel movement of interest rates means all projected market interest rates move up or down by the same amount. A ramp in interest rates means that the projected change in market interest rates occurs over the 12-month horizon on a pro-rata basis. For example, in the +100bp scenario, the projected Prime rate is projected to increase from 3.25% to 4.25% 12 months later. The Prime rate in this example will increase 1/12th of the overall increase of 100 basis points each month.

The net interest income simulation result for the 12-month horizon that covers the calendar year of 2012 is shown below:

Net Interest Income Simulation

Movement in interest rates	<u>-100bp</u>	<u>Unchanged</u>	<u>+100bp</u>	<u>+200bp</u>	<u>+300bp</u>	<u>+400bp</u>
Projected 12-month net interest income	\$ 19,169	\$ 20,397	\$ 20,686	\$ 20,947	\$ 21,220	\$ 21,570
Dollar change from unchanged scenario	\$ (1,228)	-	\$ 289	\$ 550	\$ 823	\$ 1,173
Percentage change from unchanged scenario	(6.02)%	-	1.42%	2.70%	4.03%	5.75%

Since there are limitations inherent in any methodology used to estimate the exposure to changes in market interest rates, these analyses are not intended to be a forecast of the actual effect of changes in market interest rates such as those indicated above on the Company. Further, these analyses are based on our assets and liabilities as of December 31, 2012 (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 December 31, 2012. Assets and liabilities are classified by the earliest possible repricing date or maturity, whichever occurs first.

Interest Sensitivity Gap Analysis

	Estimated maturity or repricing at December 31, 2012				
	0-3 months	4-12 months	1-5 years	Over 5 years	Total
Interest-earning assets:					
Interest-bearing deposits with banks	\$ 40,790	\$ -	\$ -	\$ -	\$ 40,790
Investment securities (a)	22,572	34,206	128,785	90,292	275,855
FRB and FHLB stock	2,601	-	-	-	2,601
Fed Funds Sold	-	-	-	-	-
Loans held for sale-mortgage banking, fixed rate	-	95,095	-	-	95,095
Loans held for sale-mortgage banking, floating rate	-	-	-	-	-
Loans held for investment, fixed rate	27,278	36,783	70,845	23,379	158,285
Loans held for investment, floating rate	117,308	5,228	6,774	1,874	131,184
Total interest-earning assets	<u>\$ 210,549</u>	<u>\$ 171,312</u>	<u>\$ 206,404</u>	<u>\$ 115,545</u>	<u>\$ 703,810</u>
Interest-bearing liabilities:					
Interest checking and money market accounts	\$ 296,006	\$ -	\$ -	\$ -	\$ 296,006
Savings	17,045	-	-	-	17,045
Time deposits under \$100,000	16,131	31,323	30,292	50,404	128,150
Time deposits \$100,000 and over	29,548	30,339	16,571	352	76,810
Short-term borrowings	11,700	-	-	-	11,700
FHLB advances	-	-	-	-	-
Other borrowings	-	-	-	-	-
Subordinated debentures	15,000	-	-	7,430	22,430
Total interest-bearing liabilities	<u>\$ 385,430</u>	<u>\$ 61,662</u>	<u>\$ 46,863</u>	<u>\$ 58,186</u>	<u>\$ 552,141</u>
Interest rate gap	<u>\$ (174,881)</u>	<u>\$ 109,650</u>	<u>\$ 159,541</u>	<u>\$ 57,359</u>	<u>\$ 151,669</u>
Cumulative interest rate gap at December 31, 2012	<u>\$ (174,881)</u>	<u>\$ (65,231)</u>	<u>\$ 94,310</u>	<u>\$ 151,669</u>	
Cumulative interest rate gap to total assets	(22.69)%	(8.46)%	12.24%	19.68%	

(a) Values for investment securities reflect the timing of the estimated principal cash flows from the securities based on par values, which vary from the amortized cost and fair value of our investments.

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

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

Since there are limitations inherent in any methodology used to estimate the exposure to changes in market interest rates, these analyses are not intended to be a forecast of the actual effect of changes in market interest rates such as those indicated above on the Company. Further, these analyses are based on our assets and liabilities as of December 31, 2012 and do not contemplate any actions we might undertake in response to changes in market interest rates.

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KPMG LLP
Suite 1501
222 South 15th Street
Omaha, NE 68102-1610

Suite 1600
233 South 13th Street
Lincoln, NE 68508-2041

Independent Auditors' Report

The Board of Directors
BNCCORP, INC.:

We have audited the accompanying consolidated financial statements of BNCCORP, INC. and its subsidiaries (the Company), which comprise the consolidated balance sheets as of December 31, 2012 and 2011, and the related consolidated statements of operations, comprehensive income, stockholders' equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with U.S. generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements referred to above present fairly in all material respects, the financial position of BNCCORP, INC. and its subsidiaries as of December 31, 2012 and 2011, and the results of their operations and their cash flows for the years then ended in accordance with U.S. generally accepted accounting principles.

KPMG LLP

Omaha, Nebraska
March 28, 2013

FINANCIAL INFORMATION

Financial Statements

BNCCORP, INC. AND SUBSIDIARIES

Consolidated Balance Sheets

As of December 31

(In thousands, except share data)

ASSETS	<u>2012</u>	<u>2011</u>
CASH AND CASH EQUIVALENTS	\$ 40,790	\$ 19,296
INVESTMENT SECURITIES AVAILABLE FOR SALE	300,549	242,630
FEDERAL RESERVE BANK AND FEDERAL HOME LOAN BANK STOCK	2,601	2,750
LOANS HELD FOR SALE-MORTGAGE BANKING	95,095	68,622
LOANS AND LEASES HELD FOR INVESTMENT	289,469	293,211
ALLOWANCE FOR CREDIT LOSSES	(10,091)	(10,630)
Net loans and leases held for investment	279,378	282,581
OTHER REAL ESTATE, net	5,131	10,145
PREMISES AND EQUIPMENT, net	15,932	16,035
ACCRUED INTEREST RECEIVABLE	2,590	2,411
OTHER ASSETS	28,710	20,688
Total assets	<u>\$ 770,776</u>	<u>\$ 665,158</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
DEPOSITS:		
Non-interest-bearing	\$ 131,593	\$ 116,864
Interest-bearing –		
Savings, interest checking and money market	313,051	269,075
Time deposits under \$100,000	128,150	128,255
Time deposits \$100,000 and over	76,810	62,061
Total deposits	649,604	576,255
SHORT-TERM BORROWINGS	11,700	8,635
GUARANTEED PREFERRED BENEFICIAL INTERESTS IN COMPANY'S SUBORDINATED DEBENTURES	22,430	22,427
ACCRUED INTEREST PAYABLE	5,045	3,609
ACCRUED EXPENSES	10,144	6,244
OTHER LIABILITIES	3,123	6,121
Total liabilities	702,046	623,291
STOCKHOLDERS' EQUITY:		
Preferred stock, \$.01 par value – Authorized 2,000,000 shares:		
Preferred Stock - 5% Series A 20,093 shares outstanding;	19,859	19,635
Preferred Stock - 9% Series B 1,005 shares outstanding;	1,029	1,052
Common stock, \$.01 par value – Authorized 35,000,000 shares; 3,300,652 and 3,301,007 shares issued and outstanding	33	33
Capital surplus – common stock	27,257	27,217
Retained earnings (deficit)	20,655	(4,508)
Treasury stock (368,001 and 367,646 shares, respectively)	(5,064)	(5,076)
Accumulated other comprehensive income, net	4,961	3,514
Total stockholders' equity	68,730	41,867
Total liabilities and stockholders' equity	<u>\$ 770,776</u>	<u>\$ 665,158</u>

See accompanying notes to consolidated financial statements.

BNCCORP, INC. AND SUBSIDIARIES

Consolidated Statements of Operations

For the Years Ended December 31

(In thousands, except per share data)

	<u>2012</u>	<u>2011</u>
INTEREST INCOME:		
Interest and fees on loans	\$ 16,750	\$ 17,651
Interest and dividends on investments -		
Taxable	6,162	7,627
Tax-exempt	967	331
Dividends	113	140
Total interest income	<u>23,992</u>	<u>25,749</u>
INTEREST EXPENSE:		
Deposits	3,857	4,773
Short-term borrowings	71	132
Subordinated debentures	1,593	1,367
Total interest expense	<u>5,521</u>	<u>6,272</u>
Net interest income	18,471	19,477
PROVISION FOR CREDIT LOSSES	100	1,625
NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES	<u>18,371</u>	<u>17,852</u>
NON-INTEREST INCOME:		
Bank charges and service fees	2,492	2,218
Wealth management revenues	1,204	1,282
Mortgage banking revenues	29,658	11,285
Gains on sales of loans, net	1,110	1,427
Gain on sales of securities, net	279	2,830
Insurance claim settlement	7,500	-
Other	695	1,195
Total non-interest income	<u>42,938</u>	<u>20,237</u>
NON-INTEREST EXPENSE:		
Salaries and employee benefits	17,040	14,972
Professional services	7,165	4,307
Data processing fees	2,859	2,673
Marketing and promotion	2,089	1,559
Occupancy	1,935	2,028
Regulatory costs	1,213	1,742
Depreciation and amortization	1,120	1,172
Office supplies and postage	684	590
Other real estate costs	2,038	2,295
Other	3,822	2,521
Total non-interest expense	<u>39,965</u>	<u>33,859</u>
Income before income taxes	21,344	4,230
Income tax expense (benefit)	(5,280)	22
Net income	\$ 26,624	\$ 4,208
Preferred stock costs	(1,462)	(1,394)
Net income available to common shareholders	<u>\$ 25,162</u>	<u>\$ 2,814</u>
Basic earnings per common share	<u>\$ 7.64</u>	<u>\$ 0.86</u>
Diluted earnings per common share	<u>\$ 7.52</u>	<u>\$ 0.86</u>

See accompanying notes to consolidated financial statements.

BNCCORP, INC. AND SUBSIDIARIES
Consolidated Statements of Comprehensive Income
For the Years Ended December 31
(In thousands)

	2012		2011
NET INCOME	\$ 26,624		\$ 4,208
Unrealized gain on securities available for sale	\$ 2,614		\$ 4,187
Reclassification adjustment for gain included in net income	<u>(279)</u>		<u>(2,830)</u>
Other comprehensive income, before tax	2,335		1,357
Income tax expense (benefit) related to items of other comprehensive income	<u>(888)</u>		<u>-</u>
Other comprehensive income	<u>1,447</u>	1,447	<u>1,357</u>
TOTAL COMPREHENSIVE INCOME	<u>\$ 28,071</u>		<u>\$ 5,565</u>

See accompanying notes to consolidated financial statements.

BNCCORP, INC. AND SUBSIDIARIES
Consolidated Statements of Stockholders' Equity
For the Years Ended December 31
(In thousands, except share data)

	Preferred Stock		Common Stock		Capital	Retained	Treasury	Accumulated	Total
	Shares	Amount	Shares	Amount	Surplus Common Stock	Earnings (Deficit)	Stock	Other Comprehensive Income	
BALANCE, December 31, 2010	21,098	\$ 20,486	3,304,339	\$ 33	\$ 27,036	\$ (7,322)	\$ (5,069)	\$ 2,157	\$ 37,321
Net income	-	-	-	-	-	4,208	-	-	4,208
Other comprehensive income	-	-	-	-	-	-	-	1,357	1,357
Preferred stock amortization, net	-	201	-	-	-	(201)	-	-	-
Accrued dividend on preferred stock	-	-	-	-	-	(1,193)	-	-	(1,193)
Impact of share-based compensation	-	-	(3,332)	-	181	-	(7)	-	174
BALANCE, December 31, 2011	21,098	\$ 20,687	3,301,007	\$ 33	\$ 27,217	\$ (4,508)	\$ (5,076)	\$ 3,514	\$ 41,867
Net income	-	-	-	-	-	26,624	-	-	26,624
Other comprehensive income	-	-	-	-	-	-	-	1,447	1,447
Preferred stock amortization, net	-	201	-	-	-	(201)	-	-	-
Accrued dividend on preferred stock	-	-	-	-	-	(1,260)	-	-	(1,260)
Impact of share-based compensation	-	-	(355)	-	40	-	12	-	52
BALANCE, December 31, 2012	21,098	\$ 20,888	3,300,652	\$ 33	\$ 27,257	\$ 20,655	\$ (5,064)	\$ 4,961	\$ 68,730

See accompanying notes to consolidated financial statements

BNCCORP, INC. AND SUBSIDIARIES
Consolidated Statements of Cash Flows
For the Years Ended December 31 (In thousands)

	2012	2011
OPERATING ACTIVITIES:		
Net income	\$ 26,624	\$ 4,208
Adjustments to reconcile net income to net cash provided by (used in) operating activities -		
Provision for credit losses	100	1,625
Provision for other real estate losses	1,700	1,775
Depreciation and amortization	1,120	1,171
Net amortization of premiums and (discounts)	5,510	2,345
Share-based compensation	52	174
Change in interest receivable and other assets, net	2,358	(652)
Loss on disposals of bank premises and equipment, net	17	50
(Gain) loss on sale of other real estate	108	(62)
Net realized gain on sales of investment securities	(279)	(2,830)
Provision (benefit) for deferred income taxes	(4,743)	-
Change in other liabilities, net	189	4,381
Gains on sales of loans, net	(1,110)	(1,427)
Unrealized gain on mortgage banking derivatives	(4,923)	-
Proceeds from sales of loans	12,141	14,831
Funding of originations of loans held for sale	(1,168,092)	(697,908)
Proceeds from sales of loans held for sale	1,142,126	660,480
Fair value adjustment for loans held for sale	(650)	(2,078)
Net cash provided by (used in) operating activities	12,248	(13,917)
INVESTING ACTIVITIES:		
Purchases of investment securities	(113,244)	(237,631)
Proceeds from sales of investment securities	8,853	100,439
Proceeds from maturities of investment securities	42,688	33,435
Purchases of Federal Reserve and Federal Home Loan Bank Stock	(481)	(73)
Sales of Federal Reserve and Federal Home Loan Bank Stock	630	185
Net decrease in participating interests in mortgage loans	-	4,888
Cash used to finance divestiture	-	(10,966)
Net (increase) decrease in loans held for investment	(7,786)	36,887
Proceeds from sales of other real estate	3,206	6,900
Additions to bank premises and equipment	(1,042)	(596)
Proceeds from sales of bank premises and equipment	8	2,793
Net cash provided by (used in) investing activities	(67,168)	(63,739)

See accompanying notes to consolidated financial statements.

BNCCORP, INC. AND SUBSIDIARIES
Consolidated Statements of Cash Flows, continued
For the Years Ended December 31 (In thousands)

	2012	2011
FINANCING ACTIVITIES:		
Net decrease in deposits held for sale	-	(30,792)
Net increase in deposits	73,349	22,590
Net increase (decrease) in short-term borrowings	3,065	(7,693)
Repayments of Federal Home Loan Bank advances	(10,810)	(1,050)
Proceeds from Federal Home Loan Bank advances	10,810	1,050
Net cash provided by (used in) financing activities	76,414	(15,895)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	21,494	(93,551)
CASH AND CASH EQUIVALENTS, beginning of year	19,296	112,847
CASH AND CASH EQUIVALENTS, end of year	\$ 40,790	\$ 19,296
SUPPLEMENTAL CASH FLOW INFORMATION:		
Interest paid	\$ 4,086	\$ 5,223
Income taxes paid (received)	\$ 707	\$ (391)
 SUPPLEMENTAL DISCLOSURE OF NONCASH INVESTING AND FINANCING ACTIVITIES:		
Additions to other real estate in settlement of loans	\$ -	\$ 6,052
Loans sold in divestiture	\$ -	\$ 65,688
Deposits transferred in divestiture	\$ -	\$ 76,654

See accompanying notes to consolidated financial statements.

BNCCORP, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements

NOTE 1. Description of Business and Significant Accounting Policies

Description of Business

BNCCORP, INC. (BNCCORP) is a registered bank holding company incorporated under the laws of Delaware. It is the parent company of BNC National Bank (together with its wholly owned subsidiary, BNC Insurance Services, Inc., collectively, the Bank). BNCCORP operates community banking and wealth management businesses in Arizona, Minnesota and North Dakota from 14 locations. The Bank also conducts mortgage banking from 12 locations in Arizona, Minnesota, Illinois, Kansas, Nebraska and Missouri.

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

Principles of Consolidation

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

Use of Estimates

The preparation of consolidated financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Significant items subject to such estimates and assumptions include the allowance for credit losses, valuation of other real estate, reserve for potential mortgage banking obligations, fair values of financial instruments (including derivatives), impairment of investments, income taxes, and the useful lives of premises and equipment. Ultimate results could differ from those estimates.

CRITICAL ACCOUNTING POLICIES

Critical accounting policies are significantly dependent on subjective assessments or estimates that may be susceptible to significant change. The following items have been identified as “critical accounting policies”.

Allowance for Credit Losses

The Bank maintains its allowance for credit losses at a level considered adequate to provide for probable losses related to the loan and lease portfolio as of the balance sheet dates. The loan and lease portfolio and other credit exposures are reviewed regularly to evaluate the adequacy of the allowance for credit losses.

The methodology used to establish the allowance for credit losses incorporates quantitative and qualitative risk considerations. Quantitative factors include our historical loss experience, delinquency information, charge-off trends, collateral values, changes in nonperforming loans and other factors. Quantitative factors also incorporate known information about individual borrowers, including sensitivity to interest rate movements or other quantifiable external factors.

Qualitative factors include the general economic environment, the state of certain industries and factors unique to our market areas. Size, complexity of individual credits, loan structure, variances from loan policies and pace of portfolio growth are other qualitative factors that are considered when we estimate the allowance for credit losses.

Our methodology has been consistently applied. However, we enhance our methodology as circumstances dictate to keep pace with the complexity of the portfolio.

The allowance for credit losses has three components as follows:

Specific Reserves. The amount of specific reserves is determined through a loan-by-loan analysis of problematic loans over a minimum size. Included in problem loans are non-accrual or renegotiated loans that meet the impairment criteria in FASB ASC 310. A loan is impaired when, based on current information, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. Any allowance on impaired loans is generally based on one of three methods: the present value of expected cash flows at the loan's effective interest rate, the loan's observable market price or the fair value of the collateral of the loan. Specific reserves may also be established for credits that have been internally classified as credits requiring management's attention due to underlying problems in the borrower's business or collateral concerns.

Reserves for Homogeneous Loan Pools. The Bank makes a significant number of loans and leases that, due to their underlying similar characteristics, are assessed for loss as "homogeneous" pools. Included in the homogeneous pools are loans which have been excluded from the specific reserve allocation.

Qualitative Reserve. Management also allocates reserves for other circumstances pertaining to the measurement period. The factors considered include, but are not limited to, prevailing trends, economic conditions, geographic influence, industry segments within the portfolio, management's assessment of credit risk inherent in the loan portfolio, delinquency data, historical loss experience and peer-group information.

Monitoring loans and analysis of loss components are the principal means by which management determines estimated credit losses are reflected in the Bank's allowance for credit losses on a timely basis. Management also considers regulatory guidance in addition to the Bank's own experience. Various regulatory agencies, as an integral part of their examination process, periodically review the allowance for credit losses. Such agencies may require additions to the allowance based on their judgment about information available to them at the time of their examination.

Loans, leases and other extensions of credit deemed uncollectible are charged off against the allowance for losses. Subsequent recoveries, if any, are credited to the allowance.

The allowance for credit losses is highly dependent upon variables affecting valuation, including appraisals of collateral, evaluations of performance as well as the amounts and timing of future cash flows expected to be received on impaired loans. These variables are reviewed periodically. Actual losses may vary from the current estimated allowance for credit losses. For nonperforming or impaired loans, appraisals are generally performed annually or whenever circumstances warrant a new appraisal. Management regularly evaluates the appraised value and costs to liquidate in order to estimate fair value. A provision for credit losses is made to adjust the allowance to the amount determined appropriate through application of the above processes.

Income Taxes

The Company files consolidated federal and unitary state income tax returns.

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

Deferred income taxes are accounted for using the asset and liability method. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect of a change in tax rates on deferred tax assets and liabilities is recognized in income in the period that includes the enactment date.

Management assesses net deferred tax assets to determine whether they are realizable based upon accounting standards and specific facts and circumstances. A valuation allowance is established to reduce net deferred tax assets to amounts that are more likely than not expected to be realized.

Other-Than-Temporary Impairment

Declines in the fair value of individual available-for-sale or held-to-maturity securities below amortized cost, which are deemed other-than-temporary, could result in a charge to earnings and establishment of a new cost basis. Write-downs for other-than-temporary impairment are recorded in non-interest income as realized losses. The Company assesses available information about our securities to determine whether impairment is other-than-temporary. The information we consider includes, but is not limited to, the following:

- Recent and expected performance of the securities;
- Financial condition of issuers or guarantors;
- Recent cash flows;
- Seniority of invested tranches and subordinated credit support;
- Vintage of origination;
- Location of collateral;
- Ratings of securities (ratings are not relied upon);
- Value of underlying collateral;
- Delinquency and foreclosure data;
- Historical losses and estimated severity of future losses;
- Credit surveillance data which summarize retrospective performance; and
- Anticipated future cash flows and prospective performance assessments.

Determining whether other-than-temporary impairment has occurred requires judgment of factors that may indicate an impairment loss has incurred. The Company adopted the guidance on other-than-temporary impairments Accounting Standards Codification (ASC) 320, *Investments-Debt and Equity Securities*, which amended the accounting for other-than-temporary impairments into credit-related and other factors. Any credit-related impairments are realized through a charge to earnings. The amount of non-credit related impairments is recognized through comprehensive income, net of income taxes.

Note 6 to these consolidated financial statements includes a summary of investment securities in a loss position at December 31, 2012 and 2011.

Fair Value

Several accounting standards require recording assets and liabilities based on their fair values. Determining the fair value of assets and liabilities can be highly subjective. The Company utilizes valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs to the extent possible. The Company determines fair value based on assumptions that market participants would use in pricing an asset or liability in the principal or most advantageous market.

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

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

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

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

Management assigns a level to assets and liabilities accounted for at fair value and uses the methodologies prescribed by ASC 820 to determine fair value.

OTHER SIGNIFICANT ACCOUNTING POLICIES

Investment Securities

Investment securities that the Bank intends to hold indefinitely as part of its asset/liability strategy, or that may be sold in response to changes in interest rates or prepayment risk are classified as available for sale. Available for sale securities are carried at fair value. Net unrealized gains and losses, net of deferred income taxes, on securities available for sale are reported as a separate component of stockholders' equity until realized (see Comprehensive Income). All securities were classified as available for sale as of December 31, 2012 and 2011, except for Federal Reserve Bank (FRB) and the Federal Home Loan Bank (FHLB) stock, which have an indeterminable maturity.

Investment securities that the Bank intends to hold until maturity are carried at cost, adjusted for amortization of premiums and accretion of discounts using a level yield method over the period to maturity. There were no such securities as of December 31, 2012 or 2011.

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

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

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

Loans Held For Sale-Mortgage Banking

Loans held for sale-mortgage banking are accounted for at fair value pursuant to the fair value option permitted by FASB ASC 825, *Financial Instruments*. Gains and losses from the changes in fair value are included in mortgage banking revenue.

Loans and Leases

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

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

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

Restructured loans are loans for which concessions, including a reduced interest rate or a deferral of interest or principal, have been granted due to the borrower's weakened financial condition. Once a loan is restructured, interest is accrued at the restructured rates when no loss of principal is anticipated. A loan that has performed in accordance with restructured terms for one year is no longer reported as a restructured loan.

Cash receipts on impaired loans are generally applied to principal except when the loan is well collateralized or there are other circumstances that support recognition of interest. When an impaired loan is in non-accrual status, cash receipts are applied to principal.

Loan Origination Fees and Costs; Other Lending Fees

For Loans and Leases Held for Investment, origination fees and costs incurred to extend credit are deferred and amortized over the term of the loan as an adjustment to yield using the interest method, except where the net amount is deemed to be immaterial.

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

Loan Servicing and Transfers of Financial Assets

The Bank sells commercial business loans to third parties. The loans are generally sold on a non-recourse basis. Sold loans are not included in the accompanying consolidated balance sheets.

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

Premises and Equipment

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

Other Real Estate Owned and Repossessed Property

Real estate properties and other assets acquired through loan foreclosures are stated at the lower of carrying amount or fair value less estimated costs to sell. If the carrying amount of an asset acquired through foreclosure is in excess of the fair value less estimated costs to sell, the excess amount is charged to the allowance for credit losses. Fair value is primarily determined based upon appraisals of the assets involved and management periodically assesses appraised values to ascertain continued relevancy of the valuation. Subsequent declines in the estimated fair value, net operating results and gains and losses on disposition of the asset are included in other non-interest expense. Operating expenses of properties are charged to other real estate costs.

Impairment of Long-Lived Assets

The Company reviews long-lived assets for impairment periodically or whenever events or changes in circumstances indicate that the carrying amount of any such asset may not be recoverable. If impairment is identified, the assets are written down to their fair value through a charge to non-interest expense.

There were no impairment charges in 2012 or 2011.

Securities Sold Under Agreements to Repurchase

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

Fair Values of Financial Instruments

The Company is required to disclose the estimated fair value of financial instruments. Fair value estimates are subjective in nature, involving uncertainties and matters of significant judgment, and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates. The following methods and assumptions are used by the Company in estimating fair value disclosures for its financial instruments.

Cash and Cash Equivalents, Non-interest-Bearing Deposits and Demand Deposits. The carrying amounts approximate fair value due to the short maturity of the instruments. The fair value of deposits with no stated maturity, such as interest checking, savings and money market accounts, is equal to the amount payable on demand at the reporting date. The intangible value of long-term customer relationships with depositors is not taken into account in the fair values disclosed.

Investment Securities Available for Sale. The fair value of the Company's securities are based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which significant assumptions are observable in the market.

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

Loans Held for Sale-Mortgage Banking. Loans held for sale-mortgage banking are accounted for at fair value pursuant to the fair value option permitted by FASB ASC 825, *Financial Instruments*.

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

Derivative Financial Instruments. The fair value of the Company's derivatives are based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which significant assumptions are observable in the market.

Interest-Bearing Deposits. Fair values of interest-bearing deposit liabilities are estimated by discounting future cash flow payment streams using rates at which comparable current deposits with comparable maturities are being issued.

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

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

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

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

Derivative Financial Instruments

FASB ASC 815, *Derivatives and Hedging*, establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. Accordingly, the Company records all derivatives at fair value.

The Company enters into interest rate lock commitments on certain mortgage loans related to our mortgage banking operations on a best efforts basis, which are commitments to originate loans whereby the interest rate on the loan is determined prior to funding. The Company also has corresponding forward sales contracts related to these interest rate lock commitments. Both the mortgage loan commitments and the related forward sales contracts are accounted for as derivatives and carried at fair value with changes in fair value recorded in income.

The Company also commits to originate and sell certain loans related to our mortgage banking operations on a mandatory delivery basis. To hedge interest rate risk the Company sells short positions in mortgage backed securities related to the loans sold on a mandatory delivery basis. The commitments to originate and short positions are accounted for as derivatives and carried at fair value with changes in fair value recorded in income.

Earnings Per Share

Basic earnings per share (EPS) excludes dilution and is computed by dividing income available to common stockholders by the weighted average number of common shares outstanding during the applicable period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the Company. Such potential dilutive instruments include stock options and contingently issuable stock. Note 24 to these consolidated financial statements includes disclosure of the Company's EPS calculations.

Comprehensive Income

Comprehensive income is the total of net income and accumulated other comprehensive income, which for the Company, is generally comprised of unrealized gains and losses on securities available for sale and unrealized gains and losses on hedging instruments qualifying for cash flow hedge accounting treatment pursuant to FASB ASC 815.

Cash and Cash Equivalents

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

Share-Based Compensation

FASB ASC 718 requires the Company to measure the cost of employee services received in exchange for an award of equity instruments based on the fair value of the award on the grant date.

At December 31, 2012, the Company had four stock-based employee compensation plans, which are described more fully in Note 27 to these consolidated financial statements.

RECENTLY ISSUED OR ADOPTED ACCOUNTING PRONOUNCEMENTS

FASB ASU 2010-20, *Receivables (Topic 310), Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*, requires significant new disclosures about the allowance for credit losses and the credit quality of financing receivables. The requirements are intended to enhance transparency regarding credit losses and the credit quality of loan and lease receivables. Under this statement, allowance for credit losses and fair value are to be disclosed by portfolio segment, while credit quality information, impaired financing receivables and nonaccrual status are to be presented by class of financing receivable. Disclosure of the nature and extent, the financial impact and segment information of troubled debt restructurings is required. The disclosures

are to be presented at the level of disaggregation that management uses when assessing and monitoring the portfolio's risk and performance. For BNCCORP, this ASU was effective as of December 31, 2011. Adoption of this ASU did not have a material impact on the Company's consolidated financial statements other than changes to disclosures. See Note 9 to these consolidated financial statements.

FASB ASU 2011-02, *Receivables (Topic 310), A Creditor's Determination of Whether a Restructuring is a Troubled Debt Restructuring*, clarifies when the restructuring of a receivable should be considered a troubled debt restructuring (TDR). FASB issued the guidance in response to constituents' concerns that creditors were inconsistently applying the guidance for indentifying TDRs. The ASU provides additional guidance for determining whether the creditor has granted a concession and whether the debtor is experiencing financial difficulty. For nonpublic companies, this ASU is effective for annual periods ending after December 15, 2012, including interim periods within those annual periods. Information related to this ASU and the related disclosures are included in Note 9 to these consolidated financial statements.

In April 2011, the FASB issued ASU 2011-03, *Transfers and Servicing (Topic 860), Reconsideration of Effective Control for Repurchase Agreements. Topic 860, Transfers and Servicing*, prescribes when an entity may or may not recognize a sale upon the transfer of financial assets subject to repurchase agreements. That determination is based, in part, on whether the entity has maintained effective control over the transferred assets. The amendments in this ASU remove from the assessment of effective control (1) the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee, and (2) the collateral maintenance implementation guidance related to that criterion. Other criteria applicable to the assessment of effective control are not changed by the amendments in this ASU. This ASU is effective for the first interim or annual period beginning on or after December 15, 2011 and should be applied prospectively to transactions or modification of existing transactions that occur on or after the effective date. The adoption of this ASU in 2012 did not have a material impact on the Company's consolidated financial statements.

In May 2011, the FASB issued ASU 2011-04, *Fair Value Measurement (Topic 820), Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. The amendments in this ASU changes the wording used to describe the requirements in U.S. GAAP for measuring fair value and for disclosing information about fair value measurements in order to improve consistency in wording between U.S. GAAP and IFRS. For BNCCORP, this ASU is effective for annual periods beginning after December 15, 2011. The adoption of this ASU in 2012 did not have a material impact on the Company's consolidated financial statements other than to change the disclosures relating to fair value measurements.

In June 2011, the FASB issued ASU 2011-05, *Presentation of Comprehensive Income (Topic 220)*, which requires companies to report total net income, each component of comprehensive income, and total comprehensive income on the face of the income statement, or as two consecutive statements. The components of comprehensive income are not changed, nor does the ASU affect how earnings per share is calculated or reported. This ASU is effective for fiscal years and interim periods beginning after December 15, 2012 for nonpublic companies. The adoption of this ASU in 2013 is not anticipated to have a material impact on the Company's consolidated financial statements.

In December 2011, the FASB issued ASU 2011-12, *Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011—5(Topic 220)*. This ASU defers the requirement to separately present items reclassified out of accumulated other comprehensive income on the face of the statement of income. Instead, the proposed standard would require those adjustments be presented either within other comprehensive income of the comprehensive income statement or in the notes as U.S. GAAP currently requires. This ASU does not change the other requirements of the new standard, which become effective as originally planned. The effective date of this ASU is expected to be consistent with the newly issued standard on comprehensive income noted above.

In December 2012, the FASB issued for public comment a draft proposal designed to improve financial reporting about expected credit losses on loans and other financial assets held by banks, financial institutions and other organizations. The proposed ASU, *Financial Instruments - Credit Losses*, proposes a new accounting model which would change the definition from inherent credit losses to expected credit losses, which could result in more timely recognition of credit losses, and also would provide additional transparency about credit risk. Stakeholders have been asked to review and provide comments to the FASB on the proposal by April 30, 2013.

RECLASSIFICATIONS

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

NOTE 2. Regulatory Capital and Current Operating Environment

BNCCORP and the Bank are subject to various regulatory capital requirements administered by the Federal banking agencies. Failure to meet capital requirements mandated by regulators can initiate certain mandatory and discretionary actions by regulators. Such actions, if undertaken, could have a direct material adverse effect on the Company's financial condition and results of operations. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, BNCCORP and the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. With increasing frequency, regulators are imposing capital requirements that are specific to individual institutions. The requirements are generally above the statutory ratios.

Actual capital amounts and ratios of BNCCORP and the Bank as of December 31 are presented in the tables below (dollars in thousands):

	Actual		For Capital Adequacy Purposes		To be Well Capitalized		Amount in Excess of Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio	Amount	Ratio
2012								
Total Capital (to risk-weighted assets):								
Consolidated	\$ 90,766	22.43 %	\$ 32,371	≥8.0 %	\$ N/A	N/A %	\$ N/A	N/A
BNC National Bank	84,003	21.06	31,905	≥8.0	39,881	10.0	44,122	11.06 %
Tier 1 Capital (to risk-weighted assets):								
Consolidated	82,908	20.49	16,185	≥4.0	N/A	N/A	N/A	N/A
BNC National Bank	78,954	19.80	15,953	≥4.0	23,929	6.0	55,025	13.80
Tier 1 Capital (to average assets):								
Consolidated	82,908	11.17	29,679	≥4.0	N/A	N/A	N/A	N/A
BNC National Bank	78,954	10.68	29,579	≥4.0	36,973	5.0	41,981	5.68
Tangible Equity (to total assets):								
Consolidated tangible equity	68,690	8.92	N/A	N/A	N/A	N/A	N/A	N/A
BNC National Bank	84,330	10.97	N/A	N/A	N/A	N/A	N/A	N/A
Tangible Common Equity (to total assets):								
Consolidated tangible common equity	47,801	6.21	N/A	N/A	N/A	N/A	N/A	N/A
2011								
Total Capital (to risk-weighted assets):								
Consolidated	\$ 65,518	17.56 %	\$ 29,850	≥8.0 %	\$ N/A	N/A %	\$ N/A	N/A
BNC National Bank	67,853	18.22	29,799	≥8.0	37,249	10.0	30,604	8.22 %
Tier 1 Capital (to risk-weighted assets):								
Consolidated	51,138	13.71	14,925	≥4.0	N/A	N/A	N/A	N/A
BNC National Bank	63,124	16.95	14,899	≥4.0	22,349	6.0	40,775	10.95
Tier 1 Capital (to average assets):								
Consolidated	51,138	7.59	26,938	≥4.0	N/A	N/A	N/A	N/A
BNC National Bank	63,124	9.41	26,831	≥4.0	33,539	5.0	29,585	4.41
Tangible Equity (to total assets):								
Consolidated tangible equity	41,803	6.28	N/A	N/A	N/A	N/A	N/A	N/A
BNC National Bank	67,028	10.12	N/A	N/A	N/A	N/A	N/A	N/A
Tangible Common Equity (to total assets):								
Consolidated tangible common equity	21,116	3.17	N/A	N/A	N/A	N/A	N/A	N/A

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

Although Tangible Common Equity (TCE) is not a regulatory capital measure, TCE is a ratio that is commonly used to assess the capital strength of banking entities. Accordingly, we have included the ratio in the preceding table.

The most recent notifications from the Office of the Comptroller of the Currency (OCC) categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. Management believes the Bank remains well capitalized through the date for which subsequent events have been evaluated.

In April 2010, BNCCORP entered into a memorandum of understanding that restricted payments related to its common stock, preferred stock, and debt. This memorandum was terminated in the fourth quarter of 2012. Accrued dividends on preferred stock are \$3.7 million and accrued interest payable on debt is \$4.8 million at December 31, 2012. Subsequent to year end, the Company began to bring these obligations current and as of February 15, 2013, we were current on the obligations.

NOTE 3. Divestiture

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

The sale did not affect our North Dakota, wealth management, or mortgage banking operations. Loans sold in the sale were \$65.7 million, deposits transferred were \$76.7 million, and the sale of the Scottsdale branch was \$2.8 million. There was no significant gain or loss incurred as a result of the divestiture.

NOTE 4. Fraud Loss on Assets Serviced by Others

As previously reported, the Company discovered fraudulent activity in April of 2010 by an external company that was servicing residential mortgage loans for the Company. Subsequently, the Company and its advisors have been diligently addressing this matter.

In 2010, we submitted claims under our fidelity insurance policies seeking to recover the insured portion of these losses. The policies together provided for total coverage of \$15 million. After we submitted the insurance claims, the insurance carriers contended our claims were not insurable and as a result we sued the insurance carriers for failure to honor the policies and for acting in bad faith.

In the third quarter of 2012, we reached a settlement with the insurers and collected \$7.5 million, which was recognized in non-interest income. After reflecting the contingent fee paid to advisors, the net pre-tax earnings from the settlement of this claim was approximately \$5.0 million in 2012.

NOTE 5. Restrictions on Cash and Cash Equivalents

The Bank is required to maintain reserve balances in cash on hand or with the FRB. The required reserve balances were \$0 as of December 31, 2012 and \$25,000 as of December 31, 2011.

NOTE 6. Investment Securities Available For Sale

Investment securities have been classified in the consolidated balance sheets according to management's intent. The Company had no securities designated as trading or held-to-maturity in its portfolio at December 31, 2012 or 2011. The carrying amount of available-for-sale securities and their approximate fair values were as follows as of December 31 (in thousands):

	2012			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. government agency mortgage-backed securities guaranteed by GNMA	\$ 60,673	\$ 3,007	\$ (93)	\$ 63,587
U.S. government agency mortgage-backed securities issued by FNMA	20,727	188	(307)	20,608
U.S. government agency small business administration pools guaranteed by SBA	13,498	87	(31)	13,554
Collateralized mortgage obligations guaranteed by GNMA/VA	122,404	1,319	(708)	123,015
Collateralized mortgage obligations issued by FNMA or FHLMC	36,167	342	(98)	36,411
Other collateralized mortgage obligations	4,656	148	(1)	4,803
State and municipal bonds	35,944	2,646	(19)	38,571
	<u>\$ 294,069</u>	<u>\$ 7,737</u>	<u>\$ (1,257)</u>	<u>\$ 300,549</u>

	2011			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. government agency mortgage-backed securities guaranteed by GNMA	\$ 57,912	\$ 1,388	\$ -	\$ 59,300
U.S. government agency mortgage-backed securities issued by FNMA	6,004	169	(2)	6,171
Collateralized mortgage obligations guaranteed by GNMA/VA	127,551	837	(841)	127,547
Collateralized mortgage obligations issued by FNMA or FHLMC	13,169	169	(17)	13,321
Other collateralized mortgage obligations	11,179	313	(5)	11,487
State and municipal bonds	22,670	2,134	-	24,804
	<u>\$ 238,485</u>	<u>\$ 5,010</u>	<u>\$ (865)</u>	<u>\$ 242,630</u>

The amortized cost and estimated fair market value of available-for-sale securities classified according to their contractual maturities at December 31, 2012, were as follows (in thousands):

	<u>Amortized Cost</u>	<u>Estimated Fair Value</u>
Due in one year or less	\$ -	\$ -
Due after one year through five years	141	143
Due after five years through ten years	13,217	13,746
Due after ten years	280,711	286,660
Total	<u>\$ 294,069</u>	<u>\$ 300,549</u>

For many types of investments, the actual payments will vary significantly from contractual maturities.

Securities carried at approximately \$59.0 million and \$73.7 million at December 31, 2012 and 2011, respectively, were pledged as collateral for public and trust deposits and borrowings, including borrowings from the FHLB and repurchase agreements with customers.

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

	<u>2012</u>	<u>2011</u>
Sales proceeds	\$ 8,853	\$ 100,439
Gross realized gains	279	3,348
Gross realized losses	-	(518)

The following table shows the Company's investments' gross unrealized losses and fair value aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at December 31 (in thousands):

Description of Securities	2012								
	Less than 12 months			12 months or more			Total		
	#	Fair Value	Unrealized Loss	#	Fair Value	Unrealized Loss	#	Fair Value	Unrealized Loss
U.S. government agency mortgage-backed securities guaranteed by GNMA	2	\$ 9,238	\$ (93)	-	\$ -	\$ -	2	\$ 9,238	\$ (93)
U.S. government agency mortgage-backed securities issued by FNMA	2	15,398	(304)	1	53	(3)	3	15,451	(307)
U.S. government agency small business administration pools guaranteed by SBA	1	3,348	(31)	-	-	-	1	3,348	(31)
Collateralized mortgage obligations guaranteed by GNMA/VA	6	36,023	(329)	4	16,601	(379)	10	52,624	(708)
Collateralized mortgage obligations issued by FNMA or FHLMC	2	8,498	(98)	-	-	-	2	8,498	(98)
Other collateralized mortgage obligations	1	602	(1)	-	-	-	1	602	(1)
State and municipal bonds	2	4,103	(19)	-	-	-	2	4,103	(19)
Total temporarily impaired securities	16	\$ 77,210	\$ (875)	5	\$ 16,654	\$ (382)	21	\$ 93,864	\$ (1,257)
Description of Securities	2011								
	Less than 12 months			12 months or more			Total		
	#	Fair Value	Unrealized Loss	#	Fair Value	Unrealized Loss	#	Fair Value	Unrealized Loss
U.S. government agency mortgage-backed securities guaranteed by GNMA	-	\$ -	\$ -	-	\$ -	\$ -	-	\$ -	\$ -
U.S. government agency mortgage-backed securities issued by FNMA	-	-	-	1	55	(2)	1	55	(2)
Collateralized mortgage obligations guaranteed by GNMA/VA	16	73,619	(841)	-	-	-	16	73,619	(841)
Collateralized mortgage obligations issued by FNMA or FHLMC	1	4,679	(17)	-	-	-	1	4,679	(17)
Other collateralized mortgage obligations	1	233	(5)	-	-	-	1	233	(5)
State and municipal bonds	-	-	-	-	-	-	-	-	-
Total temporarily impaired securities	18	\$ 78,531	\$ (863)	1	\$ 55	\$ (2)	19	\$ 78,586	\$ (865)

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

There were no securities that were other-than-temporarily impaired during 2012 or 2011.

NOTE 7. Federal Reserve Bank and Federal Home Loan Bank of Des Moines Stock

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

	<u>2012</u>	<u>2011</u>
Federal Reserve Bank Stock, at cost	\$ 1,806	\$ 1,806
Federal Home Loan Bank of Des Moines Stock, at cost	795	944
Total	<u>\$ 2,601</u>	<u>\$ 2,750</u>

There is no contractual maturity on these investments; the investments are required by counterparties.

NOTE 8. Loans and Leases

The composition of loans and leases is as follows at December 31 (in thousands):

	<u>2012</u>	<u>2011</u>
Loans held for sale-mortgage banking	<u>\$ 95,095</u>	<u>\$ 68,622</u>
Commercial and industrial	\$ 116,891	\$ 109,746
Commercial real estate	87,258	115,704
SBA	15,823	9,958
Consumer	26,614	23,038
Land and land development	31,065	29,350
Construction	<u>11,814</u>	<u>5,545</u>
	289,465	293,341
Unearned income and net unamortized deferred (fees) and costs	<u>4</u>	<u>(130)</u>
Loans, net of unearned income and unamortized (fees) and costs	289,469	293,211
Allowance for credit losses	<u>(10,091)</u>	<u>(10,630)</u>
Net loans and leases held for investment	<u>\$ 279,378</u>	<u>\$ 282,581</u>

Loans to Related Parties

Note 22 to these consolidated financial statements includes information relating to loans to executive officers, directors, principal shareholders and associates of such persons.

Loans Pledged as Collateral

The table below presents loans pledged as collateral to the Federal Home Loan Bank, Federal Reserve Bank, and the Bank of North Dakota as of December 31 (in thousands):

	<u>2012</u>	<u>2011</u>
Commercial and industrial	\$ 20,704	\$ 23,861
Commercial real estate	46,991	45,246
Consumer	14,855	14,822
	<u>\$ 82,550</u>	<u>\$ 83,929</u>

NOTE 9. Allowance for Credit Losses

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

2012							
	Commercial and industrial	Commercial real estate	SBA	Consumer	Land and land development	Construction	Total
Balance, beginning of period	\$ 1,639	\$ 5,518	\$ 436	\$ 448	\$ 2,508	\$ 81	\$ 10,630
Provision for credit losses	966	1	178	(26)	(1,086)	67	100
Loans charged off	(70)	(767)	(10)	(58)	-	-	(905)
Loan recoveries	11	38	12	18	187	-	266
Balance, end of period	<u>\$ 2,546</u>	<u>\$ 4,790</u>	<u>\$ 616</u>	<u>\$ 382</u>	<u>\$ 1,609</u>	<u>\$ 148</u>	<u>\$ 10,091</u>

2011							
	Commercial and industrial	Commercial real estate	SBA	Consumer	Land and land development	Construction	Total
Balance, beginning of period	\$ 1,362	\$ 9,818	\$ 407	\$ 1,182	\$ 1,939	\$ 57	\$ 14,765
Provision for credit losses	231	(257)	113	281	1,233	24	1,625
Loans charged off	(83)	(4,549)	(105)	(1,049)	(731)	-	(6,517)
Loan recoveries	49	506	21	34	67	-	677
	1,559	5,518	436	448	2,508	81	10,550
Transferred to other loans held for sale	80	-	-	-	-	-	80
Balance, end of period	<u>\$ 1,639</u>	<u>\$ 5,518</u>	<u>\$ 436</u>	<u>\$ 448</u>	<u>\$ 2,508</u>	<u>\$ 81</u>	<u>\$ 10,630</u>

Performing and non-accrual loans

The Bank's key credit quality indicator is the loan's performance status, defined as accrual or non-accrual. Performing loans are considered to have a lower risk of loss and are on accrual status. Non-accrual loans include loans on which the accrual of interest has been discontinued. Accrual of interest is discontinued when we believe that the borrower's financial condition is such that the collection of principal and 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. 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. Delinquent balances are determined based on the contractual terms of the loan adjusted for charge-offs and payments applied to principal.

The following table sets forth information regarding the Bank's performing and non-accrual loans at December 31 (in thousands):

	2012					
	Current	31-89 Days Past Due	90 Days or More Past Due and	Total Performing	Non-accrual	Total
Commercial and industrial:						
Business loans	\$ 64,390	\$ 3	\$ -	\$ 64,393	\$ 3,211	\$ 67,604
Agriculture	16,319	-	-	16,319	-	16,319
Owner-occupied commercial real estate	32,968	-	-	32,968	-	32,968
Commercial real estate	82,761	-	-	82,761	4,497	87,258
SBA	15,823	-	-	15,823	-	15,823
Consumer:						
Automobile	5,762	58	-	5,820	-	5,820
Home equity	3,779	-	-	3,779	-	3,779
1st mortgage	9,462	-	-	9,462	-	9,462
Other	7,534	8	11	7,553	-	7,553
Land and land development	28,273	-	-	28,273	2,792	31,065
Construction	11,814	-	-	11,814	-	11,814
Total loans held for investment	278,885	69	11	278,965	10,500	289,465
Loans held for sale	95,094	-	1	95,095	-	95,095
Total gross loans	\$ 373,979	\$ 69	\$ 12	\$ 374,060	\$ 10,500	\$ 384,560

2011

	<u>Current</u>	<u>31-89 Days Past Due</u>	<u>90 Days or More Past Due and Accruing</u>	<u>Total Performing</u>	<u>Non-accrual</u>	<u>Total</u>
Commercial and industrial:						
Business loans	\$ 62,952	\$ 1	\$ -	\$ 62,953	\$ 247	\$ 63,200
Agriculture	13,060	64	-	13,124	-	13,124
Owner-occupied commercial real estate	33,422	-	-	33,422	-	33,422
Commercial real estate	110,597	-	-	110,597	5,107	115,704
SBA	9,958	-	-	9,958	-	9,958
Consumer:						
Automobile	3,082	-	-	3,082	-	3,082
Home equity	3,347	-	-	3,347	-	3,347
1st mortgage	9,257	121	-	9,378	815	10,193
Other	6,408	8	-	6,416	-	6,416
Land and land development	29,350	-	-	29,350	-	29,350
Construction	5,545	-	-	5,545	-	5,545
Total loans held for investment	286,978	194	-	287,172	6,169	293,341
Loans held for sale	68,622	-	-	68,622	-	68,622
Total gross loans	\$ 355,600	\$ 194	\$ -	\$ 355,794	\$ 6,169	\$ 361,963

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

	<u>2012</u>	<u>2011</u>
Interest income that would have been recorded	\$ 228	\$ 406
Interest income recorded	-	4
Effect on interest income	\$ 228	\$ 402

Impaired loans

Impaired loans include loans the Bank will not be able to collect all amounts due in accordance with the terms of the loan agreement. Impaired loans include non-accruing and loans that have been modified in a troubled debt restructuring. All loans are individually reviewed for impairment.

The following table summarizes impaired loans and related allowances as of and for the years ended December 31, 2012 and 2011 (in thousands):

	2012				
	<u>Unpaid Principal</u>	<u>Recorded Investment</u>	<u>Related Allowance</u>	<u>Average Recorded Balance</u>	<u>Interest Income Recognized</u>
Impaired loans with an allowance recorded:					
Commercial and industrial:					
Business loans	\$ 3,220	\$ 3,201	\$ 601	\$ 3,204	\$ -
Agriculture	-	-	-	-	-
Owner-occupied commercial real estate	-	-	-	-	-
Commercial real estate	6,857	4,497	1,200	4,640	-
SBA	-	-	-	-	-
Consumer:					
Automobile	-	-	-	-	-
Home equity	-	-	-	-	-
1st mortgage	-	-	-	-	-
Other	-	-	-	-	-
Land and land development	661	661	300	661	-
Construction	-	-	-	-	-
Loans held for sale	-	-	-	-	-
Total impaired loans with an allowance recorded	<u>\$ 10,738</u>	<u>\$ 8,359</u>	<u>\$ 2,101</u>	<u>\$ 8,505</u>	<u>\$ -</u>
Impaired loans without an allowance recorded:					
Commercial and industrial:					
Business loans	\$ -	\$ -	\$ -	\$ -	\$ -
Agriculture	-	-	-	-	-
Owner-occupied commercial real estate	-	-	-	-	-
Commercial real estate	-	-	-	-	-
SBA	-	-	-	-	-
Consumer:					
Automobile	-	-	-	-	-
Home equity	-	-	-	-	-
1st mortgage	-	-	-	-	-
Other	-	-	-	-	-
Land and land development	2,130	2,130	-	2,130	-
Construction	-	-	-	-	-
Loans held for sale	-	-	-	-	-
Total impaired loans without an allowance recorded	<u>\$ 2,130</u>	<u>\$ 2,130</u>	<u>\$ -</u>	<u>\$ 2,130</u>	<u>\$ -</u>
TOTAL IMPAIRED LOANS	<u><u>\$ 12,868</u></u>	<u><u>\$ 10,489</u></u>	<u><u>\$ 2,101</u></u>	<u><u>\$ 10,635</u></u>	<u><u>\$ -</u></u>

2011

	<u>Unpaid Principal</u>	<u>Recorded Investment</u>	<u>Related Allowance</u>	<u>Average Recorded Balance</u>	<u>Interest Income Recognized</u>
Impaired loans with an allowance recorded:					
Commercial and industrial:					
Business loans	\$ 232	\$ 220	\$ 220	\$ 227	\$ -
Agriculture	-	-	-	-	-
Owner-occupied commercial real estate	-	-	-	-	-
Commercial real estate	7,206	5,107	777	5,238	4
SBA	-	-	-	-	-
Consumer:					
Automobile	-	-	-	-	-
Home equity	-	-	-	-	-
1st mortgage	-	-	-	-	-
Other	-	-	-	-	-
Land and land development	-	-	-	-	-
Construction	-	-	-	-	-
Loans held for sale	-	-	-	-	-
Total impaired loans with an allowance recorded	<u>\$ 7,438</u>	<u>\$ 5,327</u>	<u>\$ 997</u>	<u>\$ 5,465</u>	<u>\$ 4</u>
Impaired loans without an allowance recorded:					
Commercial and industrial:					
Business loans	\$ -	\$ -	\$ -	\$ -	\$ -
Agriculture	-	-	-	-	-
Owner-occupied commercial real estate	-	-	-	-	-
Commercial real estate	-	-	-	-	-
SBA	-	-	-	-	-
Consumer:					
Automobile	-	-	-	-	-
Home equity	-	-	-	-	-
1st mortgage	-	-	-	-	-
Other	-	-	-	-	-
Land and land development	-	-	-	-	-
Construction	-	-	-	-	-
Loans held for sale	-	-	-	-	-
Total impaired loans without an allowance recorded	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>
TOTAL IMPAIRED LOANS	<u>\$ 7,438</u>	<u>\$ 5,327</u>	<u>\$ 997</u>	<u>\$ 5,465</u>	<u>\$ 4</u>

Troubled Debt Restructuring (TDR)

Included in loans receivable, net, are certain loans that have been modified in order to maximize collection of loan balances. If the Company, for legal or economic reasons related to the borrower's financial difficulties, grants a concession compared to the original terms and conditions of the loan, the modified loan is considered a troubled debt restructuring.

During 2012, the Company adopted FASB ASU No. 2011-02, *Receivables (Topic 310), A Creditor's Determination of Whether a Restructuring is a Troubled Debt Restructuring*, which modified guidance for identifying restructurings of receivables that constitute a TDR. No additional loans modified since December 31, 2011, were identified as TDR's as a result of adopting these provisions.

The table below summarizes the amounts of restructured loans as of December 31 (in thousands):

	2012			
	<u>Accrual</u>	<u>Non-accrual</u>	<u>Total</u>	<u>Allowance</u>
Commercial and industrial:				
Business loans	\$ 101	\$ -	\$ 101	\$ 2
Agriculture	-	-	-	-
Owner-occupied commercial real estate	-	-	-	-
Commercial real estate	3,810	4,497	8,307	1,276
SBA	-	-	-	-
Consumer:				
Automobile	-	-	-	-
Home equity	-	-	-	-
1st mortgage	799	-	799	16
Other	-	-	-	-
Land and land development	3,161	-	3,161	63
Construction	-	-	-	-
Loans held for sale	-	-	-	-
	<u>\$ 7,871</u>	<u>\$ 4,497</u>	<u>\$ 12,368</u>	<u>\$ 1,357</u>

	2011			
	<u>Accrual</u>	<u>Non-accrual</u>	<u>Total</u>	<u>Allowance</u>
Commercial and industrial:				
Business loans	\$ -	\$ -	\$ -	\$ -
Agriculture	-	-	-	-
Owner-occupied commercial real estate	-	-	-	-
Commercial real estate	3,904	4,763	8,667	554
SBA	-	-	-	-
Consumer:				
Automobile	-	-	-	-
Home equity	-	-	-	-
1st mortgage	-	815	815	122
Other	-	-	-	-
Land and land development	3,366	-	3,366	67
Construction	-	-	-	-
Loans held for sale	-	-	-	-
	<u>\$ 7,270</u>	<u>\$ 5,578</u>	<u>\$ 12,848</u>	<u>\$ 743</u>

TDR concessions can include reduction of interest rates, extension of maturity dates, forgiveness of principal and/or interest due, or acceptance of real estate or other assets in full or partial satisfaction of the debt. Loan modifications are not reported as TDR's after 12 months if the loan was modified at a market rate of interest for comparable risk loans, and the loan is performing in accordance with the terms of the restructured agreement for at least six months.

When a loan is modified as a TDR, there may be a direct, material impact on the loans within the Balance Sheet, as principal balances may be partially forgiven. The financial effects of TDR's are presented in the following table and represent the difference between the outstanding recorded balance pre-modification and post-modification, for the periods ending December 31 (in thousands):

2012

	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Commercial and industrial:			
Business loans	1	\$ 202	\$ 202
Agriculture	-	-	-
Owner-occupied commercial real estate	-	-	-
Commercial real estate	-	-	-
SBA	-	-	-
Consumer:			
Automobile	-	-	-
Home equity	-	-	-
1st mortgage	-	-	-
Other	-	-	-
Land and land development	-	-	-
Construction	-	-	-
Loans held for sale	-	-	-
	<u>1</u>	<u>\$ 202</u>	<u>\$ 202</u>

2011

	<u>Number of Contracts</u>	<u>Pre-Modification Outstanding Recorded Investment</u>	<u>Post-Modification Outstanding Recorded Investment</u>
Commercial and industrial:			
Business loans	-	\$ -	\$ -
Agriculture	-	-	-
Owner-occupied commercial real estate	-	-	-
Commercial real estate	2	4,280	3,938
SBA	-	-	-
Consumer:	-	-	-
Automobile	-	-	-
Home equity	-	-	-
1st mortgage	1	1,380	815
Other	-	-	-
Land and land development	-	-	-
Construction	-	-	-
Loans held for sale	-	-	-
	<u>3</u>	<u>\$ 5,660</u>	<u>\$ 4,753</u>

Loans that were non-accrual prior to modification remain on non-accrual for at least six months following modification. Non-accrual TDR loans that have performed according to the modified terms for six months may be returned to accruing status. Loans that were accruing prior to modification remain on accrual status after the modification as long as the loan continues to perform under the new terms.

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

	<u>2012</u>	<u>2011</u>
Interest income that would have been recorded	\$ 691	\$ 651
Interest income recorded	329	145
Effect on interest income	<u>\$ 362</u>	<u>\$ 506</u>

The amount of additional funds committed to borrowers who are in TDR status was \$232,000 at December 31, 2012 and \$364,000 at December 31, 2011.

TDRs are evaluated separately in the Bank's allowance methodology based on the expected cash flows or collateral values for loans in this status.

The Bank had \$0 of restructured loans that were modified in a troubled-debt restructuring within the previous 12 months for which there was a payment default (i.e. 90 days delinquent).

NOTE 10. Other Real Estate

Other real estate (ORE) includes property acquired through foreclosure, property in judgment and in-substance foreclosures. ORE is carried at fair value less estimated selling costs. Each property is evaluated regularly and the amounts provided to decrease the carrying amount are included in non-interest expense. A summary of the activity related to ORE is presented below for the years ended December 31 (in thousands):

	<u>2012</u>	<u>2011</u>
Balance, beginning of year	\$ 10,145	\$ 12,706
Transfers from nonperforming loans	-	6,052
Real estate sold	(3,206)	(6,900)
Net gains (losses) on sale of assets	(108)	62
Provision	(1,700)	(1,775)
Balance, end of year	<u>\$ 5,131</u>	<u>\$ 10,145</u>

The following is a summary of ORE as of December 31 (in thousands):

	<u>2012</u>	<u>2011</u>
Other real estate	\$ 8,146	\$ 15,530
Valuation allowance	(3,015)	(5,385)
Other real estate, net	<u>\$ 5,131</u>	<u>\$ 10,145</u>

NOTE 11. Premises and Equipment, net

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

	<u>2012</u>	<u>2011</u>
Land and improvements	\$ 5,220	\$ 5,220
Buildings and improvements	11,704	11,593
Leasehold improvements	655	536
Furniture, fixtures and equipment	8,854	8,799
Total cost	26,433	26,148
Less accumulated depreciation and amortization	(10,501)	(10,113)
Net premises and equipment	<u>\$ 15,932</u>	<u>\$ 16,035</u>

Depreciation and amortization expense totaled approximately \$1.1 million and \$1.2 million for the years ended December 31, 2012 and 2011, respectively.

NOTE 12. Deposits

The scheduled maturities of time deposits as of December 31, 2012 are as follows (in thousands):

2013	\$	107,341
2014		22,441
2015		5,086
2016		12,092
2017		7,244
Thereafter		<u>50,756</u>
	\$	<u>204,960</u>

At December 31, 2012 and 2011, the Bank had \$65.0 million and \$59.8 million, respectively, of time deposits that had been acquired through a broker.

The following table shows a summary of interest expense by product type as of December 31 (in thousands):

	<u>2012</u>	<u>2011</u>
Savings	\$ 15	\$ 13
Interest checking	197	352
Money market	449	588
Time deposits	<u>3,196</u>	<u>3,820</u>
	<u>\$ 3,857</u>	<u>\$ 4,773</u>

Deposits Received from Related Parties

Note 22 to these consolidated financial statements includes information relating to deposits received from executive officers, directors, principal shareholders and associates of such persons.

NOTE 13. Short-Term Borrowings

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

	<u>2012</u>	<u>2011</u>
Federal reserve borrowings-U. S. Treasury tax and loan retainer	\$ -	\$ -
Repurchase agreements with customers, renewable daily, interest payable monthly, rates ranging from 0.30% to 1.00% in 2012, and from 0.40% to 3.25% in 2011, secured by government agency collateralized mortgage obligations	<u>11,700</u>	<u>8,635</u>
	<u>\$ 11,700</u>	<u>\$ 8,635</u>

The weighted average interest rate on short-term borrowings outstanding as of December 31, 2012 and 2011 was 0.38% and 0.92%, respectively.

Customer repurchase agreements are used by the Bank to acquire funds from customers where the customers are required, or desire, to have their funds supported by collateral consisting of government, government agency or other types of securities. The repurchase agreement is a promise to sell these securities to a customer at a certain price and repurchase them at a future date at that same price plus interest accrued at an agreed upon rate. The Bank uses customer repurchase agreements in its liquidity plan as well as an accommodation to customers. At December 31, 2012, \$11.7 million of securities sold under repurchase agreements, with a weighted average interest rate of 0.38%, were collateralized by government agency collateralized mortgage obligations having a

market value of \$22.6 million and unamortized principal balances of \$21.2 million. At December 31, 2011, \$8.6 million of securities sold under repurchase agreements, with a weighted average interest rate of 0.92% were collateralized by government agency collateralized mortgage obligations having a market value of \$21.0 million and unamortized principal balances of \$19.5 million.

NOTE 14. Federal Home Loan Bank Advances

As of December 31, 2012, the Bank had \$0 of FHLB advances outstanding. At December 31, 2012, the Bank has mortgage loans with unamortized principal balances of approximately \$73.3 million and securities with unamortized principal balances of approximately \$4.5 million which were pledged as collateral to the FHLB. The Bank has the ability to draw advances up to approximately \$47.9 million based upon the mortgage loans and securities that are currently pledged, subject to a requirement to purchase additional FHLB stock.

NOTE 15. Other Borrowings

The following table presents selected information regarding other borrowings at December 31, 2012 (in thousands):

Unsecured Borrowing Lines:

	<u>Line</u>	<u>Outstanding</u>	<u>Available</u>
Bank of North Dakota	\$ 2,000	\$ -	\$ 2,000
US Bank	10,000	-	10,000
Zions First National Bank	12,000	-	12,000
Total	<u>\$ 24,000</u>	<u>\$ -</u>	<u>\$ 24,000</u>

Secured Borrowing Lines:

	<u>Collateral Pledged</u>	<u>Line</u>	<u>Outstanding</u>	<u>Available</u>
Bank of North Dakota	\$ 13,383	\$ 10,707	\$ -	\$ 10,707
Total		<u>\$ 10,707</u>	<u>\$ -</u>	<u>\$ 10,707</u>

At December 31, 2012 the pledged collateral was comprised of municipal bonds and collateralized mortgage obligations.

NOTE 16. Guaranteed Preferred Beneficial Interest's in Company's Subordinated Debentures

In July 2007, BNCCORP issued \$15.0 million of floating rate subordinated debentures. The interest rate paid on the securities is equal to the three month LIBOR plus 1.40%. The interest rate at December 31, 2012 was 1.76% and the interest rate reset on January 2, 2013 to 1.71%. The subordinated debentures mature on October 1, 2037. The subordinated debentures may be redeemed at par and the corresponding debentures may be prepaid at the option of BNCCORP, subject to approval by the FRB.

In July 2000, BNCCORP issued \$7.5 million of subordinated debentures at 12.05%. The subordinated debentures are subject to mandatory redemption on July 19, 2030. On or after July 19, 2010, the subordinated debentures may be redeemed and the corresponding debentures may be prepaid at the option of BNCCORP at declining redemption prices. Because regulations related to the regulatory capital treatment of these subordinated debentures have changed, we currently believe these subordinated debentures may be redeemable at par. Redemption is subject to approval by the FRB.

Commencing in January 2010, BNCCORP deferred interest payments on its subordinated debentures as permitted pursuant to contractual terms of the agreements. While the subordinated debenture agreements permit interest to

be deferred for up to 60 months, interest on the subordinated debentures continues to accrue during deferment. At December 31, 2012, accrued interest owed on the subordinated debentures aggregated \$4.8 million, which is included in interest payable. At December 31, 2011, accrued interest owed on the subordinated debentures aggregated \$3.2 million, which is included in interest payable. Subsequent to December 31, 2012, the Company began to bring these obligations current and as of January 19, 2013, we were current on the obligations.

The agreements that contractually permit the deferral of interest on the subordinated debentures require that dividends on junior securities be suspended while interest payments on the subordinated debentures are deferred.

NOTE 17. Stockholders' Equity

On January 16, 2009, BNCCORP received net proceeds of approximately \$20.1 million through the sale of shares of non-voting senior preferred stock to the U.S. Department of the Treasury under the Capital Purchase Program (CPP). The Treasury Department also received a warrant exercisable for shares of an additional class of BNCCORP, INC. preferred stock, which has an aggregate liquidation preference of approximately \$1.0 million. The Treasury Department exercised this warrant on January 16, 2009.

As a result of participating in the CPP, the Company issued two series of preferred stock. Both series of stock are perpetual and classified as non-voting.

The first series of stock pays dividends at 5%, of its liquidation preference, per annum until the fifth anniversary of the Treasury Department's investment and thereafter pays a dividend of 9%. There were 20,093 shares of this series outstanding as of December 31, 2012 and 2011. Each share has a liquidation preference of \$1,000 per share. This series of shares can not be redeemed without prior approval from regulatory authorities.

The second series of preferred pays dividends at 9%, of its liquidation preference, per annum and may not be redeemed until the first series has been redeemed. There were 1,005 shares of this series outstanding at December 31, 2012 and 2011.

As a result of deferring interest on the subordinated debentures, BNCCORP was contractually required to cease payment of dividends on the CPP preferred stock beginning with the quarterly payment due February 2010. At December 31, 2012, the Company has recorded the accrued dividends aggregating \$3.7 million which is included in other liabilities in the consolidated financial statements. At December 31, 2011, the Company has recorded the accrued dividends aggregating \$2.5 million which is included in other liabilities in the consolidated financial statements. Subsequent to December 31, 2012, the Company began to bring these obligations current and as of February 15, 2013, we were current on the obligations.

BNCCORP and the Bank are subject to certain minimum capital requirements (see Note 2 to these consolidated financial statements). BNCCORP is subject to certain restrictions on the amount of dividends it may declare without prior regulatory approval pursuant to the Federal Reserve Act. The terms of the preferred stock issued under the CPP precludes certain dividend payments to common shareholders and certain repurchases of outstanding shares of common stock until the preferred shares have been redeemed.

Regulatory restrictions exist regarding the ability of the Bank to transfer funds to BNCCORP in the form of cash dividends. Approval of the Office of the Comptroller of the Currency (OCC), the Bank's principal regulator, is required for the Bank to pay dividends to BNCCORP in excess of the Bank's net profits from the current year plus retained net profits for the preceding two years.

On May 30, 2001, BNCCORP's Board of Directors adopted a rights plan intended to protect stockholder interests in the event BNCCORP becomes the subject of a takeover initiative that BNCCORP's Board believes could deny BNCCORP's stockholders the full value of their investment. This plan does not prohibit the Board from considering any offer that it deems advantageous to its stockholders.

The rights were issued to each common stockholder of record on May 30, 2001, and they will be exercisable only if a person acquires, or announces a tender offer, that would result in ownership of, 15% or more of BNCCORP's outstanding common stock. The rights plan was amended in 2011 such that it now expires on May 30, 2021.

NOTE 18. Fair Value Measurements

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

	Carrying Value at December 31, 2012				Twelve Months Ended December 31, 2012
	Total	Level 1	Level 2	Level 3	Total gains/(losses)
ASSETS					
Securities available for sale	\$ 300,549	\$ -	\$ 300,549	\$ -	\$ -
Loans held for sale	95,095	-	95,095	-	649
Commitments to originate mortgage loans	4,499	-	4,499	-	2,183
Total assets at fair value	<u>\$ 400,143</u>	<u>\$ -</u>	<u>\$ 400,143</u>	<u>\$ -</u>	<u>\$ 2,832</u>
LIABILITIES					
Commitments to sell mortgage loans	\$ 2,233	\$ -	\$ 2,233	\$ -	\$ 2,143
Mortgage banking short positions	52	-	52	-	(52)
Total liabilities at fair value	<u>\$ 2,285</u>	<u>\$ -</u>	<u>\$ 2,285</u>	<u>\$ -</u>	<u>\$ 2,091</u>
	Carrying Value at December 31, 2011				Twelve Months Ended December 31, 2011
	Total	Level 1	Level 2	Level 3	Total gains/(losses)
ASSETS					
Securities available for sale	\$ 242,630	\$ -	\$ 242,630	\$ -	\$ -
Loans held for sale	68,622	-	68,622	-	2,078
Commitments to originate mortgage loans	2,316	-	2,316	-	1,828
Total assets at fair value	<u>\$ 313,568</u>	<u>\$ -</u>	<u>\$ 313,568</u>	<u>\$ -</u>	<u>\$ 3,906</u>
LIABILITIES					
Commitments to sell mortgage loans	\$ 4,376	\$ -	\$ 4,376	\$ -	\$ (3,906)
Total liabilities at fair value	<u>\$ 4,376</u>	<u>\$ -</u>	<u>\$ 4,376</u>	<u>\$ -</u>	<u>\$ (3,906)</u>

The unrealized gains recognized during 2012 resulted from a new hedging strategy where loans are sold on a mandatory delivery basis. We began to deliver loans on a mandatory delivery basis as it generally improves margins in the mortgage banking operations. We also sell short positions in mortgage-backed securities to hedge interest rate risk on the loans committed for mandatory delivery. The commitments to originate mortgage banking loans and our short positions are derivatives and recorded at fair value. The fair values of the commitments to originate loans under mandatory delivery are generally greater than the fair value of our short positions. This asymmetry resulted in unrealized gains in 2012.

The Company may also be required from time to time to measure certain other assets at fair value on a nonrecurring basis in accordance with U.S. generally accepted accounting principles. These adjustments to fair value usually result from the application of the lower of cost or market accounting or write-down of individual assets. For assets measured at fair value on a nonrecurring basis the following table provides the level of valuation assumptions used to determine the carrying value at December 31 (in thousands):

2012

	Total	Level 1	Level 2	Level 3	Total gains/ (losses)
Impaired loans ⁽¹⁾	\$ 8,394	\$ -	\$ 8,394	\$ -	\$ (1,431)
Other real estate ⁽²⁾	5,131	-	5,131	-	(1,808)
Total	\$ 13,525	\$ -	\$ 13,525	\$ -	\$ (3,239)

2011

	Total	Level 1	Level 2	Level 3	Total gains/ (losses)
Impaired loans ⁽¹⁾	\$ 4,330	\$ -	\$ 4,330	\$ -	\$ (65)
Other real estate ⁽²⁾	10,145	-	10,145	-	(1,713)
Total	\$ 14,475	\$ -	\$ 14,475	\$ -	\$ (1,778)

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

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

NOTE 19. Fair Value of Financial Instruments

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

	Level in Fair Value Measurement Hierarchy	2012		2011	
		Carrying Amount	Fair Value	Carrying Amount	Fair Value
Assets:					
Cash and cash equivalents	Level 1	\$ 40,790	\$ 40,790	\$ 19,296	\$ 19,296
Investment securities available for sale	Level 2	300,549	300,549	242,630	242,630
Federal Reserve Bank and Federal Home Loan Bank stock	Level 2	2,601	2,601	2,750	2,750
Loans held for sale-mortgage banking	Level 2	95,095	95,095	68,622	68,622
Commitments to originate mortgage loans	Level 2	4,499	4,499	2,315	2,315
Loans and leases held for investment, net	Level 2	279,378	278,705	282,581	282,787
Accrued interest receivable	Level 2	2,590	2,590	2,411	2,411
		<u>\$ 725,502</u>	<u>\$ 724,829</u>	<u>\$ 620,605</u>	<u>\$ 620,811</u>
Liabilities and Stockholders' Equity:					
Deposits, noninterest-bearing	Level 2	\$ 131,593	\$ 131,593	\$ 116,864	\$ 116,864
Deposits, interest-bearing	Level 2	518,011	520,795	459,391	460,506
Short-term borrowings	Level 2	11,700	11,700	8,635	8,635
Accrued interest payable	Level 2	5,045	5,045	3,609	3,609
Accrued expenses	Level 2	10,144	10,144	6,244	6,244
Commitments to sell mortgage loans	Level 2	2,233	2,233	4,376	4,376
Mortgage banking short positions	Level 2	52	52	-	-
Guaranteed preferred beneficial interests in Company's subordinated debentures	Level 2	22,430	14,849	22,427	12,731
		<u>\$ 701,208</u>	<u>\$ 696,411</u>	<u>\$ 621,546</u>	<u>\$ 612,965</u>
Financial instruments with off-balance-sheet risk:					
Commitments to extend credit	Level 2	\$ -	\$ 94	\$ -	\$ 40
Standby and commercial letters of credit	Level 2	\$ -	\$ 14	\$ -	\$ 25

NOTE 20. Financial Instruments with Off-Balance-Sheet Risk

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

Commitments to Extend Credit

Commitments to extend credit are agreements to lend to a customer, which are binding, provided there is no violation of any condition in the contract, and generally have fixed expiration dates or other termination clauses. The contractual amount represents the Bank's exposure to credit loss in the event of default by the borrower. At December 31, 2012, based on current information, no losses were anticipated as a result of these commitments. The Bank manages this credit risk by using the same credit policies it applies to loans. Collateral is obtained to secure commitments based on management's credit assessment of the borrower. The collateral may include marketable securities, receivables, inventory, equipment or real estate. Since the Bank expects many of the commitments to expire without being drawn, total commitment amounts do not necessarily represent the Bank's future liquidity requirements related to such commitments.

In our mortgage banking operations, we commit to extend credit for purposes of originating residential loans. We underwrite these commitments to determine whether each loan meets criteria established by the secondary market for residential loans. See Note 1 and 18 to these consolidated financial statements for more information on financial instruments and derivatives related to our mortgage banking operations.

Standby and Commercial Letters of Credit

Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Commercial letters of credit are issued on behalf of customers to ensure payment or collection in connection with trade transactions. In the event of a customer's nonperformance, the Bank's credit loss exposure is up to the letter's contractual amount. At December 31, 2012, based on current information, no losses were anticipated as a result of these commitments. Management assesses the borrower's credit to determine the necessary collateral, which may include marketable securities, real estate, accounts receivable and inventory. Since the conditions requiring the Bank to fund letters of credit may not occur, the Bank expects our liquidity requirements related to such letters of credit to be less than the total outstanding commitments.

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

	2012		2011	
	Fixed Rate	Variable Rate	Fixed Rate	Variable Rate
Commitments to extend credit	\$ 17,738	\$ 37,378	\$ 12,063	\$ 36,165
Standby and commercial letters of credit	523	937	1,051	1,462

In addition to the amounts in the table above, our mortgage banking commitments to fund loans totaled \$161.0 million at December 31, 2012 and \$93.5 million at December 31, 2011. Also, our mortgage banking commitments to sell loans totaled \$253.2 million at December 31, 2012 and \$160.1 million at December 31, 2011.

Mortgage Banking Obligations

Through its mortgage banking operations, the Company originates and sells residential mortgage loans servicing released to third parties. These loans are sold without recourse to the Company. However, standard industry practices require representations and warranties which generally require sellers to reimburse a portion of the sales proceeds if a sold loan defaults or pays off shortly after the sale of the loan (i.e. generally within four months of the sale). The following is a summary of activity related to mortgage banking reimbursement obligations at December 31 (in thousands):

	<u>2012</u>	<u>2011</u>
Balance, beginning of period	\$ 800	\$ 501
Provision	849	404
Write offs	(149)	(105)
Balance, end of period	<u>\$ 1,500</u>	<u>\$ 800</u>

NOTE 21. Guarantees and Contingent Consideration

Guaranteed Preferred Beneficial Interests in Company's Subordinated Debentures

BNCCORP fully and unconditionally guarantees the Company's subordinated debentures.

Performance and Financial Standby Letters of Credit

As of December 31, 2012 and 2011, the Bank had outstanding \$942 thousand and \$1.7 million, respectively, of performance standby letters of credit and \$4.7 million and \$6.1 million, respectively, of financial standby letters of credit. Performance standby letters of credit are irrevocable obligations to the beneficiary on the part of the Bank to make payment on account of any default by the account party in the performance of a nonfinancial or commercial obligation. Financial standby letters of credit are irrevocable obligations to the beneficiary on the part of the Bank to repay money for the account of the account party or to make payment on account of any indebtedness undertaken by the account party, in the event that the account party fails to fulfill its obligation to the beneficiary. Under these arrangements, the Bank could, in the event of the account party's nonperformance, be required to pay a maximum of the amount of issued letters of credit. The Bank has recourse against the account party up to and including the amount of the performance standby letter of credit. The Bank evaluates each account party's creditworthiness on a case-by-case basis and the amount of collateral obtained varies and is based on management's credit evaluation of the account party.

NOTE 22. Related-Party/Affiliate Transactions

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

In the normal course of business, loans are granted to, and deposits are received from, executive officers, directors, principal stockholders and associates of such persons. The aggregate dollar amount of these loans was \$2.6 million and \$1.3 million at December 31, 2012 and 2011, respectively. Originations in 2012 and 2011 totaled \$1.5 million and \$709,000, respectively. Loan paydowns in 2012 and 2011 were \$162,000 and \$124,000, respectively. The total amount of deposits received from these parties was \$2.3 million and \$1.9 million at December 31, 2012 and 2011, respectively. Loans to, and deposits received from, these parties were made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with unrelated persons and do not involve more than the normal risk of collection.

The Federal Reserve Act limits amounts of, and requires collateral on, extensions of credit by the Bank to BNCCORP, and with certain exceptions, its non-bank affiliates. There are also restrictions on the amounts of investment by the Bank in stocks and other subsidiaries of BNCCORP and such affiliates and restrictions on the acceptance of their securities as collateral for loans by the Bank. As of December 31, 2012, BNCCORP and its affiliates were in compliance with these requirements.

NOTE 23. Income Taxes

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

	<u>2012</u>	<u>2011</u>
Current:		
Federal	\$ 343	\$ 17
State	7	5
	<u>350</u>	<u>22</u>
Deferred:		
Federal	6,106	997
State	1,523	386
Valuation allowance	(13,259)	(1,383)
	<u>(5,630)</u>	<u>-</u>
Total	<u>\$ (5,280)</u>	<u>\$ 22</u>

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

	<u>2012</u>	<u>2011</u>
Tax expense (benefit) at 34% statutory rate	\$ 7,257	\$ 1,438
State taxes (net of Federal benefit)	1,198	388
Tax-exempt interest	(287)	(116)
Cash surrender values of bank-owned life insurance	(178)	(179)
Other, net	(11)	(126)
	<u>7,979</u>	<u>1,405</u>
Deferred tax valuation allowance	(13,259)	(1,383)
	<u>\$ (5,280)</u>	<u>\$ 22</u>

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

	<u>2012</u>	<u>2011</u>
Deferred tax asset:		
Loans, primarily due to credit losses	\$ 4,639	\$ 4,607
Fraud loss on assets serviced by others	-	5,709
Acquired intangibles	216	236
Net operating loss carryforwards	1,387	3,456
Alternative minimum tax credits	900	612
Other real estate owned	1,694	2,602
Other	463	414
Deferred tax asset	<u>9,299</u>	<u>17,636</u>
Deferred tax liability:		
Unrealized gain on securities available for sale	2,468	1,581
Discount accretion on securities	983	1,571
Leases	-	84
Premises and equipment	759	739
Other	291	347
Deferred tax liability	<u>4,501</u>	<u>4,322</u>
	4,798	13,314
Valuation allowance	<u>(7)</u>	<u>(13,266)</u>
Net deferred tax asset	<u>\$ 4,791</u>	<u>\$ 48</u>

At December 31, 2011, a valuation allowance related to our net deferred tax assets was required because the realization of tax benefits related to deferred tax assets was not sufficiently certain. During 2012, virtually all of the valuation allowance related to deferred tax assets was reversed because of several consecutive profitable quarters and management's assessment that it was more likely than not that benefits related to deferred tax assets would be realized.

The Company is able to carry forward federal tax net operating losses aggregating \$1.525 million as of December 31, 2012. The carry forward period is 17 to 19 years. The Company is able to carry forward state tax net operating losses aggregating \$12.7 million as of December 31, 2012. The state net operating losses expire between 2014 and 2032.

The Company files consolidated federal and unitary state income tax returns where allowed. Tax years ended December 31, 2009 through 2012 remain open to federal examination. During 2010, the Internal Revenue Service opened an examination of the Company's 2009 federal income tax return. The audit was completed in 2011. Tax years ended December 31, 2008 through 2012 remain open to state examinations.

NOTE 24. Earnings Per Share

The following table shows the amounts used in computing per share results (in thousands, except share and per share data):

	<u>2012</u>	<u>2011</u>
Net income per share was calculated as follows:		
Denominator for basic earnings per share:		
Average common shares outstanding	3,291,660	3,282,182
Dilutive common stock options	52,620	-
Denominator for diluted earnings per share	<u>3,344,280</u>	<u>3,282,182</u>
Numerator (in thousands):		
Net income	\$ 26,624	\$ 4,208
Preferred stock costs	(1,462)	(1,394)
Net income available to common shareholders	<u>\$ 25,162</u>	<u>\$ 2,814</u>
Basic earnings per common share	<u>\$ 7.64</u>	<u>\$ 0.86</u>
Diluted earnings per common share	<u>\$ 7.52</u>	<u>\$ 0.86</u>

NOTE 25. Benefit Plans

BNCCORP has a qualified, tax-exempt 401(k) savings plan covering all employees of BNCCORP and its subsidiaries who meet specified age and service requirements. Under the plan, eligible employees may elect to defer up to 75% of compensation each year not to exceed the dollar limits set by law. At their discretion, BNCCORP and its subsidiaries may provide matching contributions to the plan. In 2012 and 2011, BNCCORP and its subsidiaries made matching contributions of up to 50% of eligible employee deferrals up to a maximum employer contribution of 5% of employee compensation. Generally, all participant contributions and earnings are fully and immediately vested. The Company makes its matching contribution during the first calendar quarter following the last day of each calendar year and an employee must be employed by the Company on the last day of the calendar year in order to receive the current year's employer match. The anticipated matching contribution is expensed monthly over the course of the calendar year based on employee contributions made throughout the year. The Company made matching contributions of \$464,000 and \$378,000 for 2012 and 2011, respectively. Under the investment options available under the 401(k) savings plan prior to January 28, 2008, employees could elect to invest their salary deferrals in BNCCORP common stock. At December 31, 2012, the assets in the plan totaled \$17.7 million and included \$853,000 (83,000 shares) invested in BNCCORP common stock. On January 28, 2008, the Company voluntarily delisted from the NASDAQ Global Market and deregistered its common stock under the Securities Exchange Act of 1934 (as amended). As a result, the participants are prohibited from making new investments of the Company's common stock in the plan.

NOTE 26. Commitments and Contingencies

Employment Agreements and Noncompete Covenants

The Company has entered into an employment agreement with its President and Chief Executive Officer. The Company has also entered into an employment agreement with its Chief Credit Officer. However, the agreement governing the preferred stock issued to the Treasury Department precludes payment of “golden parachutes” to senior executive officers of the Company so long as the preferred stock is owned by the Treasury Department.

Leases

The Bank has entered into operating lease agreements for certain facilities and equipment used in its operations. Rent expense for the years ended December 31, 2012 and 2011 was \$908,000 and \$970,000, respectively, for facilities, and \$37,000 and \$42,000, respectively, for equipment and other items. At December 31, 2012, the total minimum annual base lease payments for operating leases were as follows (in thousands):

2013	\$	720
2014		439
2015		448
2016		447
2017		263
Thereafter		1,536

NOTE 27. Share-Based Compensation

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

Total shares in plan, total shares available, and maximum restricted shares available as of December 31, 2012 are as follows:

	1995 Stock Incentive Plan	2002 Stock Incentive Plan	2006 Stock Incentive Plan	2010 Stock Incentive Plan	Total
Total Shares in Plan	250,000	125,000	200,000	250,000	825,000
Total Shares Available	79,451	-	15,850	250,000	345,301
Maximum Restricted Shares Available	79,451	-	15,850	35,000	130,301

The Company recognized share-based compensation expense of \$31,000 and \$42,000 for the years ended December 31, 2012 and 2011, respectively, related to restricted stock.

The tax benefits associated with share-based compensation would have been approximately \$14,000 and \$10,000 for the years ended December 31, 2012 and 2011, respectively, if the Company had not been in a full valuation allowance.

At December 31, 2012, the Company had \$3,000 of unamortized restricted stock compensation. At December 31, 2011, the Company had \$35,000 of unamortized restricted stock compensation. Restricted shares of stock granted generally have vesting and amortization periods of at least three years.

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

	<u>2012</u>		<u>2011</u>	
	<u>Number Restricted Stock Shares</u>	<u>Weighted Average Grant Date Fair Value</u>	<u>Number Restricted Stock Shares</u>	<u>Weighted Average Grant Date Fair Value</u>
Nonvested, beginning of year	9,100	\$ 4.47	20,500	\$ 4.42
Granted	-	-	-	-
Vested	(5,800)	6.16	(11,400)	4.39
Forfeited	-	-	-	-
Nonvested, end of year	<u>3,300</u>	1.50	<u>9,100</u>	4.47

The Company granted 240,000 stock options on March 17, 2010. The stock options have a two year vesting period and a ten year contractual term. The exercise price is equal to the market price on grant date, which was \$3.00. The fair value of each share option is estimated on the date of grant using a Black-Scholes methodology with the assumptions noted below:

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

The Company recognized share-based compensation expense of \$29,000 and \$140,000 for the years ended December 31, 2012 and 2011, respectively, related to share options. At December 31, 2012, the Company had \$0 of unamortized compensation cost related to non-vested stock options granted.

The Company is permitted to issue shares from treasury shares already held when options are exercised.

Following is a summary of vested stock options and options expected to vest as of December 31, 2012:

	<u>Stock Options Outstanding</u>	<u>Stock Options Currently Exercisable</u>	<u>Stock Options Vested and Expected to Vest</u>
Number	228,000	228,000	228,000
Weighted-average exercise price	\$3.00	\$3.00	\$3.00
Weighted-average remaining contractual term	7.3 years	7.3 years	7.3 years

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

	2012		2011	
	Options to Purchase Shares	Weighted Average Exercise Price	Options to Purchase Shares	Weighted Average Exercise Price
Outstanding, beginning of year	236,500	\$ 3.14	269,700	\$ 3.49
Granted	-	\$ -	-	\$ -
Exercised	(8,500)	\$ 7.00	-	\$ -
Forfeited	-	\$ -	(33,200)	\$ 5.99
Outstanding, end of year	<u>228,000</u>	\$ 3.00	<u>236,500</u>	\$ 3.14
Exercisable, end of year	<u>228,000</u>	\$ 3.00	<u>122,500</u>	\$ 3.28
Weighted average fair value of				
Granted	<u>\$ -</u>		<u>\$ -</u>	
Exercised	<u>\$ 3.76</u>		<u>\$ -</u>	
Forfeited	<u>\$ -</u>		<u>\$ 2.82</u>	

Following is a summary of the status of options outstanding at December 31, 2012:

	Outstanding Options			Exercisable Options	
	Number	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number	Weighted Average Exercise Price
Options with exercise prices of:					
\$3.00 to \$3.00	228,000	7.3 years	\$ 3.00	228,000	\$ 3.00

NOTE 28. Condensed Financial Information-Parent Company Only

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

Parent Company Only
Condensed Balance Sheets
As of December 31
(In thousands, except per share data)

	<u>2012</u>	<u>2011</u>
Assets:		
Cash and cash equivalents	\$ 12,630	\$ 3,242
Investment securities available for sale	-	-
Investment in subsidiaries	78,961	63,129
Receivable from subsidiaries	1,179	155
Other	2,337	241
Total assets	<u>\$ 95,107</u>	<u>\$ 66,767</u>
Liabilities and stockholders' equity:		
Subordinated debentures	\$ 22,430	\$ 22,427
Payable to subsidiaries	54	42
Accrued expenses and other liabilities	9,305	6,396
Total liabilities	<u>31,789</u>	<u>28,865</u>
Preferred stock, \$.01 par value. Authorized 2,000,000 shares:		
Preferred Stock - 5% Series A 20,093 shares issued and outstanding;	19,859	19,635
Preferred Stock - 9% Series B 1,005 shares issued and outstanding;	1,029	1,052
Common stock, \$.01 par value – Authorized 35,000,000 shares 3,300,652 and 3,301,007 shares issued and outstanding	33	33
Capital surplus – common stock	27,257	27,217
Retained earnings	20,655	(4,508)
Treasury stock (368,001 and 367,646 shares, respectively)	(5,064)	(5,076)
Accumulated other comprehensive loss, net of income taxes	(451)	(451)
Total stockholders' equity	<u>63,318</u>	<u>37,902</u>
Total liabilities and stockholders' equity	<u>\$ 95,107</u>	<u>\$ 66,767</u>

Parent Company Only
Condensed Statements of Operations
For the Years Ended December 31
(In thousands)

	2012	2011
Income:		
Management fee income	\$ 1,652	\$ 1,661
Interest	8	6
Gain on sale of securities	-	-
Other	38	38
Total income	1,698	1,705
Expenses:		
Interest	1,631	1,402
Salaries and benefits	856	748
Legal and other professional	618	517
Depreciation and amortization	1	1
Other	887	831
Total expenses	3,993	3,499
Loss before income tax expense (benefit) and equity in income of subsidiaries	(2,295)	(1,794)
Income tax expense (benefit)	3,089	(16)
Income (loss) before equity in income of subsidiaries	794	(1,810)
Equity in earnings of subsidiaries	25,830	6,018
Net income	\$ 26,624	\$ 4,208

Parent Company Only
Condensed Statements of Cash Flows
For the Years Ended December 31
(In thousands)

	<u>2012</u>	<u>2011</u>
Operating activities:		
Net income	\$ 26,624	\$ 4,208
Adjustments to reconcile net income to net cash provided by (used in) operating activities -		
Equity in undistributed income of subsidiaries	(25,830)	(6,018)
Depreciation and amortization	3	3
Share based compensation	40	181
Change in prepaid expenses and other receivables	(3,109)	953
Net realized gain on sale of investment securities	-	-
Change in accrued expenses and other liabilities	1,660	1,538
Net cash provided by (used in) operating activities	<u>(612)</u>	<u>865</u>
Investing activities:		
Dividend paid by subsidiaries	10,000	-
Proceeds from sale of investment securities	-	-
Net cash provided by (used in) investing activities	<u>10,000</u>	<u>-</u>
Financing activities:		
Proceeds from issuance of preferred stock	-	-
Payment of preferred stock dividends	-	-
Net cash provided by (used in) financing activities	<u>-</u>	<u>-</u>
Net increase (decrease) in cash and cash equivalents	9,388	865
Cash and cash equivalents, beginning of year	3,242	2,377
Cash and cash equivalents, end of year	<u>\$ 12,630</u>	<u>\$ 3,242</u>
Supplemental cash flow information:		
Interest paid	<u>\$ 3,259</u>	<u>\$ -</u>
Income taxes received	<u>\$ 699</u>	<u>\$ (391)</u>

NOTE 29. Subsequent Events

The Company has evaluated subsequent events from the balance sheet date through March 28, 2013, the date at which the financial statements were available to be issued, and determined there are no other items to disclose.

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CORPORATE DATA

Investor Relations

Gregory K. Cleveland, CPA (Inactive)
President/CEO
602-852-3526

Timothy J. Franz, CPA (Inactive)
Chief Financial Officer
612-305-2213

General Inquiries:

BNCCORP, INC.
322 East Main Avenue
Bismarck, North Dakota 58501
Telephone (701) 250-3040
Facsimile (701) 222-3653
E-mail Inquiries:
corp@bncbank.com

Annual Meeting

The 2013 annual meeting of stockholders will be held on Wednesday, June 19, 2013 at 8:30 a.m. (Central Daylight Time) at BNC National Bank, Second Floor Conference Room, 322 East Main Avenue, Bismarck, ND 58501.

Independent Public Accountants

KPMG LLP
233 South 13th Street
Suite 1600
Lincoln, NE 68508

Securities Listing

BNCCORP, INC.'s common stock is traded on the OTC Markets under the symbol: "BNCC." There were 63 record holders of the Company's common stock at March 13, 2013.

COMMON STOCK PRICES

For the Years Ended December 31,

	2012 ⁽¹⁾		2011 ⁽¹⁾	
	High	Low	High	Low
First Quarter	\$6.77	\$2.02	\$3.15	\$1.55
Second Quarter	\$2.50	\$2.00	\$3.09	\$2.15
Third Quarter	\$6.50	\$2.11	\$2.50	\$1.75
Fourth Quarter	\$10.55	\$6.10	\$3.15	\$1.41

(1) The quotes represent the high and low closing sales prices as reported by OTC Markets.

Stock Transfer Agent and Registrar

American Stock Transfer & Trust Company
59 Maiden Lane, Plaza Level
New York, NY 10038
(800) 937-5449

DIRECTORS, BNCCORP, INC.

Mark W. Sheffert
Chairman of the Board of BNCCORP, INC.
Chairman and Chief Executive
Officer, Manchester Companies, Inc.

Gregory K. Cleveland, CPA (Inactive)
President and
Chief Executive Officer

Tracy Scott, CPA (Inactive)
Retired Co-Founder of BNCCORP, INC.

Gaylen Ghylin, CPA (Inactive)
EVP, Secretary and CFO
Tiller Corporation d/b/a Barton Sand &
Gravel Co., Commercial Asphalt Co. and
Barton Enterprises, Inc.

Richard M. Johnsen, Jr.
Chairman of the Board and
Chief Executive Officer,
Johnsen Trailer Sales, Inc.

Michael O'Rourke
Attorney / Author

Stephen H. Roman
Partner
FirstStrategic LLC

DIRECTORS BNC National Bank

Gregory K. Cleveland
Shawn Cleveland
Timothy J. Franz
Dave Hoekstra
Mark E. Peiler
Scott Spillman

SUBSIDIARIES

BNCCORP National Bank

Headquarters:

20175 North 67th Ave
Glendale, AZ 85308

Bank Branches:

Bismarck Main
322 East Main Avenue
Bismarck, ND 58501

Bismarck South
219 South 3rd Street
Bismarck, ND 58504

Bismarck North
801 East Century Avenue
Bismarck, ND 58503

Primrose Assisted Living Apartments
1144 College Drive
Bismarck, ND 58501

Touchmark on West Century
1000 West Century Avenue
Bismarck, ND 58503

Crosby
107 North Main Street
Crosby, ND 58730

Garrison
92 North Main
Garrison, ND 58540

Kenmare
103 1st Avenue SE
Kenmare, ND 58746

Linton
104 North Broadway
Linton, ND 58552

Stanley
210 South Main
Stanley, ND 58784

Watford City
205 North Main
Watford City, ND 58854

Minneapolis
240 Investors Bldg (Baker Center)
733 Marquette Ave, South
Minneapolis, MN 55402

Perimeter
17550 North Perimeter Drive
Scottsdale, AZ 85255

Mortgage Banking Branches:

Scottsdale
17550 North Perimeter Drive
Scottsdale, AZ 85255

Glendale
6685 W. Beardsley
Glendale, AZ 85383

Golden Valley
650 Douglas Drive
Golden Valley, MN 55422

Wichita
2868 North Ridge Road
Wichita, KS 67205

Andover
511 North Andover Road
Andover, Kansas 67002

Overland Park
7007 College Boulevard
Overland Park, KS 66211

Topeka
2110 SW Belle Avenue
Topeka, KS 66614

Moline
800 36th Avenue
Moline, IL 61265

Independence
19045 E. Valley View
Independence, MO 64055

Lincoln
6120 Apples Way
Lincoln, NE 68516

Omaha
4900 Dodge Street
Omaha, NE 68132

EXECUTIVE OFFICERS OF BNCCORP and Subsidiaries

Gregory K. Cleveland, CPA (Inactive)
President and Chief Executive Officer

Timothy J. Franz, CPA (Inactive)
Chief Financial Officer

Shawn Cleveland, CPA
Chief Operating Officer,
BNC National Bank

Dave Hoekstra, CPA (Inactive)
Chief Credit Officer and
President, BNC National Bank – North Dakota Market

Mark E. Peiler, CFA
Senior Vice President - Chief Investment Officer



BNCCORP, INC.

322 East Main Avenue
Bismarck, ND 58501

(701) 250-3040
www.bnccorp.com

OTCMarkets

