

2013 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 10 locations in Arizona, Minnesota, North Dakota, Illinois, Kansas, Nebraska and Missouri.



Timothy J. Franz
President and CEO

TO OUR SHAREHOLDERS, CUSTOMERS, EMPLOYEES AND COMMUNITY:

This is my first Annual Report letter to BNC's constituents and it rightfully begins by recognizing Mr. Gregory Cleveland, whose untimely passing occurred in 2013. Greg co-founded BNCCORP, INC. and infused integrity, ingenuity, passion and demanding standards into every facet of BNC. I am grateful for the opportunity to have worked closely with Greg, as he represented the best in American business. We honor him by continuing to deliver on his vision for the Company.

BNC's performance in 2013 was highlighted by solid earnings performance, despite a decrease in mortgage banking revenue due to rising interest rates, as well as continued improvement in asset quality and a sound capital base to support future growth. As we enter 2014, we continue to work hard at building our core bank to achieve long term results for our shareholders and the communities we serve.

Solid Financial Performance

In 2013 BNC's net income was \$8.6 million (before preferred stock costs), resulting in diluted earnings per common share of \$2.11. These results generated a return on average assets of 1.07% and a return on average common equity of 15.15%. When compared to community banking peers, returns of this magnitude are considered very healthy. Our shareholders are being rewarded and employees can be proud of BNC's accomplishments.

We generated these results by increasing net interest income, capturing mortgage banking revenues early in 2013 and reducing operating costs.

Net interest income increased to \$19.8 million in 2013, or 7.4%. This improvement is significant as low interest rates and a flat yield curve have been major impediments for our industry. We were able to overcome these obstacles by growing our balance sheet by \$72.3 million, or 9.4%, during 2013. Continuing to improve net interest income will be integral to our future success.

Non-interest income was \$28.2 million in 2013, excluding life insurance benefits, a substantial decrease compared to 2012 as interest rates spiked in the second quarter resulting in lower residential housing re-finance activity and revenues throughout the mortgage banking industry. Fortunately, we captured mortgage banking revenues when they were available early in the year. While it will be harder to generate mortgage banking revenues in the current environment, housing finance is a durable business, we are committed to it and have a solid foundation to build upon. Look for us to improve originations related to home purchases by adding producers in 2014, while many of our peers exit the business due to increasing complex regulation.

Non-interest expenses declined significantly last year, after excluding non-recurring charges for impairment aggregating \$1.5 million in 2013 and legal matters aggregating \$2.5 million in 2012. When these costs are excluded, non-interest expenses decreased by \$3.0 million, or 8.0%, in 2013. We reduced costs by downsizing back office mortgage operations and being disciplined overall about the way we spend money. While the cost of complying with increasing complex banking regulations is rising and represents a significant challenge to many community banks, BNC has compliance competency at our core and we are well suited to address these challenges.

Moving Forward from a Position of Strength

Largely due to strong financial performances in the past two years, we enter 2014 from a position of strength. Our regulatory capital ratios are very strong. Our balance sheet is clean and conservative, as demonstrated by our relatively low level of non-performing assets which were down to \$6.7 million, or 0.79% of total assets, at the end of 2013. We remain vigilant with respect to credit quality and will long remember the sources of credit problems that plagued community banking in the recent "Great Recession".

The investing marketplace appears to agree that BNC's financial condition is strong; the U.S. Treasury auctioned its investment in our preferred stock in March of 2014 and private investors paid a full price for our shares. On behalf of American taxpayers, we are pleased to note the Treasury made money on its investment in BNC. The new owners of our preferred stock are sophisticated investors with significant involvement in community banking. Their willingness to pay a full price can be viewed as a vote of confidence in our financial condition and prospects.

We view our solid financial condition not as an end in itself, but as a starting point and a sturdy platform to build upon. Our assets grew by more than \$72 million to \$843 million at the end of 2013 and one of our key strategic objectives is to continue growing our core banking operations. Our strategy to grow core banking is key priority now, to reverse the planned shrinking of the balance sheet that enabled us to weather the hardships of a few years ago. While this was a successful strategy, our current banking assets have not rebounded to pre-recession levels. We aim to increase our ratio of loans held for investment to core deposits, which is 44.0%, to a more satisfactory level that can drive higher income.

Our loans held for investment grew by \$28.5 million, or 9.8% in 2013 after shrinking for several years and we plan to continue this growth in 2014. Realistically, growing loans is a challenge for virtually all community banks and will not be quickly or easily done. However, BNC is well positioned to accomplish this critical strategic objective. Our business banking operations in North Dakota are in the midst of the most robust local economy in the U.S. Our 2013 originations of SBA loans in the Phoenix area ranked as the fourth highest in this market. We expect our business bankers in both of these regions to originate more loans in 2014 than in 2013 and proudly boast about the quality of our business bankers. The talent level of these professionals is exceptional and we are seeking to add comparable talent.

Growing cost-effective deposits is the most critical element of community banking. Banks that are proficient at growing deposits generate significant value. In recent years, we have done this exceedingly well, as demonstrated by the \$73.6 million, or 11.3%, growth in deposits during 2013. It is noteworthy that our deposits have grown by almost \$147 million from the end of 2011 to the end of 2013. We continue to emphasize deposit growth and will be relentless and entrepreneurial in continued pursuit of deposits.

More than Just Typical Banking

The quality of the BNC banking experience is a strong competitive advantage. In recent years we have sponsored impressive (and free) wealth management seminars. These seminars have featured nationally recognized financial speakers including John Mauldin and Dr. Lacy Hunt. Participants in the conference held in the summer of 2013 session could easily have profited from Dr. Hunt's assessment of the U.S. economy. We are well into planning efforts for our 2014 conference which is currently scheduled for September 25, 2014. You are invited to attend.

We continue to make investments in technology to make banking with us more convenient and accessible for our customers. We have mobile phone banking, remote deposit services and have long offered internet banking products for banking and mortgage banking customers. It may surprise you to learn that our internet mortgage banking group originated more than \$679 million of loans in 2013 and is able to serve the housing industry from "border to border and shore to shore". If you are a little old fashioned, like me, please visit a branch. I am confident our people will treat you well.

Creating Value

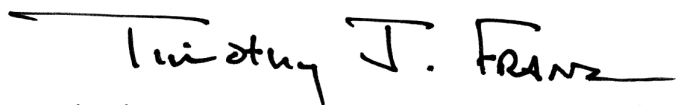
Value is created by working hard, nurturing lasting relationships, being innovative, and by properly distinguishing between good ideas and bad ideas.

In banking, we measure value created with a variety of financial metrics. According to most of these measures BNC has excelled in recent periods. However, one should know and never forget, the process of creating value begins and ends with quality people.

Our people are dedicated to high standards, hard work, serving clients and improving the communities where they live and work. In a year when it would have been easy for BNC's employees to lose focus, they stayed on track. I know firsthand the good things they do for our clients. It is a genuine honor to be associated with the employees of BNC.

We appreciate the trust placed in BNC by our customers, the confidence of our shareholders, and the sound guidance of our Board of Directors, and look forward to delivering strong results in 2014 and beyond.

Sincerely,



Timothy J. Franz
President and Chief Executive Officer

BNCCORP, INC.
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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,

	2013	2012	2011	2010	2009
Income Statement Data from Continuing Operations:					
Total interest income	\$ 23,706	\$ 23,992	\$ 25,749	\$ 33,510	\$ 44,588
Total interest expense	3,861	5,521	6,272	10,238	14,899
Net interest income	19,845	18,471	19,477	23,272	29,689
Provision for credit losses	700	100	1,625	5,750	27,000
Non-interest income	29,285	42,938	20,237	23,973	16,013
Fraud loss on assets serviced by others	-	-	-	26,231	-
Non-interest expense, excluding fraud loss on assets serviced by others	35,981	39,965	33,859	37,257	39,103
Income tax expense (benefit)	3,822	(5,280)	22	72	(1,625)
Net income (loss)	\$ 8,627	\$ 26,624	\$ 4,208	\$ (22,065)	\$ (18,776)
Preferred stock costs	(1,320)	(1,462)	(1,394)	(1,333)	(1,254)
Net income (loss) available to common shareholders	\$ 7,307	\$ 25,162	\$ 2,814	\$ (23,398)	\$ (20,030)
Balance Sheet Data: (at end of period)					
Total assets	\$ 843,123	\$ 770,776	\$ 665,158	\$ 747,069	\$ 868,083
Investments securities available for sale	435,719	300,549	242,630	137,032	212,661
Federal Reserve Bank and Federal Home Loan Bank stock	2,729	2,601	2,750	2,862	3,048
Loans held for sale-mortgage banking	32,870	95,095	68,622	29,116	24,130
Loans and leases held for investment, net of unearned income	317,928	289,469	293,211	350,501	517,108
Other loans held for sale, net	-	-	-	70,501	-
Allowance for credit losses	(9,847)	(10,091)	(10,630)	(14,765)	(18,047)
Deposits held for sale	-	-	-	107,446	-
Total deposits	723,229	649,604	576,255	661,111	755,963
Core deposits	658,704	584,604	516,436	594,152	640,169
Short-term borrowings	19,967	11,700	8,635	16,329	10,190
Federal Home Loan Bank advances	-	-	-	-	15,000
Guaranteed preferred beneficial interests in Company's subordinated debentures	22,432	22,430	22,427	24,134	22,890
Preferred stockholders' equity	21,098	20,888	20,687	20,486	20,285
Common stockholders' equity	48,767	47,842	21,180	16,835	36,980
Book value per common share outstanding	\$ 14.45	\$ 14.49	\$ 6.42	\$ 5.09	\$ 11.24
Book value per common share outstanding, excluding accumulated other comprehensive income	\$ 14.89	\$ 12.99	\$ 5.35	\$ 4.44	\$ 11.53
Tangible book value	\$ 14.45	\$ 14.49	\$ 6.42	\$ 5.09	\$ 11.24
Earnings Performance / Share Data from Continuing Operations:					
Return (loss) on average total assets	1.07%	3.74%	0.61%	(2.79)%	(2.09)%
Return (loss) on average common stockholders' equity	15.15%	90.04%	17.32%	(97.12)%	(37.20)%
Efficiency ratio	73.24%	65.08%	85.26%	134.38%	85.56%
Net interest margin	2.65%	2.85%	3.11%	3.20%	3.58%
Net interest spread	2.54%	2.63%	2.89%	2.95%	3.37%
Basic earnings (loss) per common share	\$ 2.22	\$ 7.64	\$ 0.86	\$ (7.13)	\$ (6.14)
Diluted earnings (loss) per common share	\$ 2.11	\$ 7.52	\$ 0.86	\$ (7.13)	\$ (6.14)
Average common shares outstanding	3,297,235	3,294,562	3,282,182	3,281,719	3,261,831
Average common and common equivalent shares	3,468,390	3,344,280	3,282,182	3,281,719	3,273,722
Shares outstanding at year end	3,374,601	3,300,652	3,301,007	3,304,339	3,290,219
Other Key Ratios					
Nonperforming assets to total assets	0.79%	2.03%	2.45%	4.09%	4.97%
Nonperforming loans to total assets	0.67%	1.36%	0.93%	2.39%	4.13%
Nonperforming loans to loans and leases held for investment	1.77%	3.63%	2.10%	5.10%	6.94%
Net loan charge-offs to average loans and leases held for investment	(0.332)%	(0.225)%	(1.780)%	(1.530)%	(3.235)%
Allowance for credit losses to total loans	2.81%	2.62%	2.94%	3.84%	3.11%
Allowance for credit losses to total nonperforming loans	175%	96%	172%	83%	50%

Quarterly Financial Data

	2013				
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	YTD
Interest income	\$ 5,649	\$ 5,560	\$ 5,560	\$ 6,937	\$ 23,706
Interest expense	1,016	977	944	924	3,861
Net interest income	4,633	4,583	4,616	6,013	19,845
Provision for credit losses	700	-	-	-	700
Net interest income after provision for credit losses	3,933	4,583	4,616	6,013	19,145
Non-interest income	11,324	8,352	5,001	4,608	29,285
Non-interest expense	9,397	9,059	9,451	8,074	35,981
Income before income taxes	5,860	3,876	166	2,547	12,449
Income tax expense (benefit)	2,075	1,400	(321)	668	3,822
NET INCOME	\$ 3,785	\$ 2,476	\$ 487	\$ 1,879	\$ 8,627
Preferred stock costs	(324)	(327)	(330)	(339)	(1,320)
Net income available to common shareholders	<u>\$ 3,461</u>	<u>\$ 2,149</u>	<u>\$ 157</u>	<u>\$ 1,540</u>	<u>\$ 7,307</u>
Basic earnings per common share	<u>\$ 1.05</u>	<u>\$ 0.65</u>	<u>\$ 0.05</u>	<u>\$ 0.46</u>	<u>\$ 2.22</u>
Diluted earnings per common share	<u>\$ 1.00</u>	<u>\$ 0.62</u>	<u>\$ 0.05</u>	<u>\$ 0.44</u>	<u>\$ 2.11</u>
Average common shares:					
Basic	3,297,352	3,297,352	3,297,004	3,314,807	3,297,235
Diluted	3,466,884	3,467,749	3,475,269	3,481,232	3,468,390

	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	<u>\$ 1,210</u>	<u>\$ 4,668</u>	<u>\$ 14,676</u>	<u>\$ 4,608</u>	<u>\$ 25,162</u>
Basic earnings per common share	<u>\$ 0.37</u>	<u>\$ 1.42</u>	<u>\$ 4.46</u>	<u>\$ 1.40</u>	<u>\$ 7.64</u>
Diluted earnings per common share	<u>\$ 0.37</u>	<u>\$ 1.42</u>	<u>\$ 4.41</u>	<u>\$ 1.34</u>	<u>\$ 7.52</u>
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

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). As of December 31, 2013, 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 10 locations in Arizona, Minnesota, Illinois, Kansas, Nebraska and Missouri.

Operating Strategy

We are a community bank that focuses on business banking. We 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.* We provide a high level of customer service to establish and maintain long-term relationships. We believe that many of our competitors emphasize retail banking or focus on large companies, leaving the small and mid-sized business market underserved. Our consistent focus on the needs of such small and mid-sized businesses allows us to compete effectively in this market segment.
- *Diversification of products and services.* We offer a wide variety of banking, mortgage banking, and wealth management products and services to meet the financial needs of our customers, establish new relationships and expand our business opportunities. We seek to leverage our existing relationships by cross-selling our products and services.
- *Expand opportunistically.* We emphasize organic growth within the markets that we serve and look to opportunistically expand into new lines of business and attractive markets. Organic growth in North Dakota is an emphasis as we believe the need for our services is particularly strong due to increased demand generated by the energy and agricultural industries. In Arizona, our organic growth focuses on small businesses and the SBA arena. In recent years, we have expanded our mortgage banking operations. The mortgage banking business can be strategically counter cyclical to community banking and it has been a good example of opportunistic expansion.
- *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.
- *Emphasize deposit growth.* Growing low-cost core deposits as a key strategy. Federal depository insurance offers us a strategic advantage that permits us 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 have recently initiated specialty deposit accounts service where we provide “lockbox” services for customers. This type of depository product is capable of significant growth.

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>2013</u>	<u>2012</u>
<u>SELECTED INCOME STATEMENT DATA</u>		
Interest income	\$ 23,706	\$ 23,992
Interest expense	<u>3,861</u>	<u>5,521</u>
Net interest income	19,845	18,471
Provision for credit losses	700	100
Non-interest income	29,285	42,938
Non-interest expense	<u>35,981</u>	<u>39,965</u>
Income before income taxes	12,449	21,344
Income tax expense (benefit)	<u>3,822</u>	<u>(5,280)</u>
Net income	8,627	26,624
Preferred stock costs	<u>(1,320)</u>	<u>(1,462)</u>
Net income available to common shareholders	<u>\$ 7,307</u>	<u>\$ 25,162</u>
<u>EARNINGS PER SHARE DATA</u>		
Basic earnings per common share	\$ 2.22	\$ 7.64
Diluted earnings per common share	\$ 2.11	\$ 7.52

The following is a brief overview of recent periods:

- In 2013 the Company increased Net Interest Income over 2012 through a combination of loan and deposit growth, disciplined product pricing and effective cash deployment.
- Mortgage related revenue declined in 2013 as interest rates rose in the second half of the year. The Company also received a \$1.1 million life insurance payments and SBIC partnership income of \$1.587 million in 2013. Many of our sources of non-interest income, excluding mortgage banking revenue, posted improvements in 2013. In 2012, the Company took advantage of low interest rates to earn significant mortgage revenue as customers rushed to refinance mortgages. Non-recurring revenue related to a legal settlement of \$7.5 million in 2012 also bolstered earnings. For more information see discussion of non- interest income that follows in the management discussion & analysis (MD&A).
- Credit quality continued to improve in 2013 from an already stabilized credit quality in 2012. At December 31, 2013 our non-performing assets (NPA's) were 0.79% of total assets. NPA's decreased from \$15.6 million at December 31, 2012 to \$6.7 million at December 31, 2013, and the ratio of the allowance for loan losses to non-performing loans improved to 175% at December 31, 2013.
- Non-interest expense declined in 2013 partially in response to the decline in the mortgage production volume as interest rates rose. Also, in 2013, we recorded an impairment charge of \$1.5 million related to the consolidation of our Minnesota operations. In 2012, professional fees included a \$2.5 million fee paid to our advisors when the insurance claim litigation was settled.
- In 2013, we maintained a more normalized effective tax rate of 30.7%. In 2012, we recorded a significant tax benefit when the valuation allowance related to deferred tax assets was reversed.

General

Net income in 2013 was \$8.627 million, or \$2.11 per diluted share, compared to net income of \$26.624 million, or \$7.52 per diluted share in 2012.

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,			For the Year ended December 31,			For the Year ended December 31,		
	2013			2012			2011		
	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 banks	\$ 54,726	\$ 144	0.26%	\$ 35,172	\$ 80	0.23%	\$ 63,570	\$ 161	0.25%
Taxable investments	315,722	5,948	1.88%	241,923	6,195	2.56%	204,463	7,606	3.72%
Tax-exempt investments	46,086	1,496	3.25%	31,096	967	3.11%	9,123	331	3.63%
Participating interests in mortgage loans	-	-	0.00%	-	-	0.00%	1,101	45	4.09%
Loans held for sale-mortgage banking	56,779	1,890	3.33%	66,288	2,263	3.41%	33,317	1,342	4.03%
Loans and leases held for investment	284,344	14,228	5.00%	284,507	14,487	5.09%	328,091	16,264	4.96%
Allowance for credit losses	(9,928)	-	0.00%	(10,560)	-	0.00%	(12,754)	-	0.00%
Total interest-earning assets	747,729	23,706	3.17%	648,426	23,992	3.70%	626,911	25,749	4.11%
Non-interest-earning assets:									
Cash and due from banks	10,337			11,155			8,997		
Other	49,483			51,597			53,360		
Total assets	<u>\$ 807,549</u>			<u>\$ 711,178</u>			<u>\$ 689,268</u>		
Liabilities and Stockholders' Equity									
Deposits:									
Interest checking and money market accounts	\$ 341,128	576	0.17%	\$ 271,089	645	0.24%	\$ 253,054	940	0.37%
Savings	19,857	15	0.08%	15,549	16	0.10%	12,655	13	0.10%
Certificates of deposit:									
Under \$100,000	125,641	1,535	1.22%	127,446	2,368	1.86%	139,254	2,812	2.02%
\$100,000 and over	81,196	534	0.66%	65,563	828	1.26%	71,432	1,008	1.41%
Total interest-bearing deposits	567,822	2,660	0.47%	479,647	3,857	0.80%	476,395	4,773	1.00%
Borrowings:									
Short-term borrowings	18,948	41	0.22%	13,329	70	0.53%	15,583	132	0.85%
FHLB advances	-	-	0.00%	203	1	0.49%	11	-	0.00%
Other borrowings	-	-	0.00%	-	-	0.00%	-	-	0.00%
Subordinated debentures	22,431	1,160	5.17%	22,428	1,593	7.10%	23,437	1,367	5.83%
Total interest-bearing liabilities	609,201	3,861	0.63%	515,607	5,521	1.07%	515,426	6,272	1.22%
Non-interest-bearing demand accounts	118,783	-	0.00%	125,367	-	0.00%	124,208	-	0.00%
Total deposits and interest-bearing liabilities	727,984			640,974			639,634		
Other non-interest-bearing liabilities	9,093			16,636			11,201		
Total liabilities	737,077			657,610			650,835		
Stockholders' equity	70,472			53,568			38,433		
Total liabilities and stockholders' equity	<u>\$ 807,549</u>			<u>\$ 711,178</u>			<u>\$ 689,268</u>		
Net interest income		<u>\$ 19,845</u>			<u>\$ 18,471</u>			<u>\$ 19,477</u>	
Net interest spread			<u>2.54%</u>			<u>2.63%</u>			<u>2.89%</u>
Net interest margin			<u>2.65%</u>			<u>2.85%</u>			<u>3.11%</u>
Ratio of average interest-earning assets to average interest-bearing liabilities	<u>122.74%</u>			<u>125.76%</u>			<u>121.63%</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, 2013 Compared to 2012			For the Years Ended December 31, 2012 Compared to 2011		
	Change Due to			Change Due to		
	Volume	Rate	Total	Volume	Rate	Total
Interest Earned on Interest-Earning Assets						
Federal funds sold/interest-bearing due from banks	\$ 50	\$ 14	\$ 64	\$ (66)	\$ (15)	\$ (81)
Taxable investments	1,622	(1,869)	(247)	1,233	(2,644)	(1,411)
Tax-exempt investments	485	44	529	690	(54)	636
Participating interests in mortgage loans	-	-	-	(23)	(23)	(46)
Loans held for sale- mortgage banking	(318)	(55)	(373)	1,153	(232)	921
Loans held for investment	(8)	(251)	(259)	(2,208)	432	(1,776)
Total increase (decrease) in interest income	<u>1,831</u>	<u>(2,117)</u>	<u>(286)</u>	<u>779</u>	<u>(2,536)</u>	<u>(1,757)</u>
Interest Expense on Interest-Bearing Liabilities						
Interest checking and money market accounts	144	(213)	(69)	63	(358)	(295)
Savings	4	(5)	(1)	3	-	3
Certificates of Deposit:						
Under \$100,000	(33)	(800)	(833)	(229)	(215)	(444)
\$100,000 and over	166	(460)	(294)	(79)	(101)	(180)
Short-term borrowings	22	(51)	(29)	(17)	(45)	(62)
FHLB advances	-	(1)	(1)	-	1	1
Other borrowings	-	-	-	-	-	-
Subordinated debentures	-	(433)	(433)	-	226	226
Total increase (decrease) in interest expense	<u>303</u>	<u>(1,963)</u>	<u>(1,660)</u>	<u>(259)</u>	<u>(492)</u>	<u>(751)</u>
Increase (decrease) in net interest income	<u>\$ 1,528</u>	<u>\$ (154)</u>	<u>\$ 1,374</u>	<u>\$ 1,038</u>	<u>\$ (2,044)</u>	<u>\$ (1,006)</u>

Net interest income was \$19.845 million in 2013 compared to \$18.471 million in 2012, an increase of \$1.374 million or 7.4%. The net interest margin decreased to 2.65% for the year ended December 31, 2013 from 2.85% in 2012. In 2013, net interest income was higher as the impact of lower interest rates was offset by the impact of higher balances of assets and liabilities. Our ability to lower our cost of funds in the future may be limited because interest rates are currently historically low. In 2013, earning assets increased as loans held for investment and investments available for sale increased as we deployed funds from new deposits and liquidity built in prior periods. As 2013 progressed, we continued to increase commercial lending, particularly in North Dakota.

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. 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.

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)	
	2013	2012	2013 – 2012	
			\$	%
Bank charges and service fees	\$ 2,675	\$ 2,492	\$ 183	7 % (a)
Wealth management revenues	1,260	1,204	56	5 %
Mortgage banking revenues	19,344	29,658	(10,314)	(35) % (b)
Gains on sales of loans, net	1,632	1,110	522	47 % (c)
Gains on sales of securities, net	1,247	279	968	347 % (d)
Other	2,072	695	1,377	198 % (e)
Subtotal non-interest income	28,230	35,438	(7,208)	(20) %
Insurance claim settlement	-	7,500	(7,500)	(100) % (f)
Life insurance benefits received	1,055	-	1,055	100 % (f)
Total non-interest income	<u>\$ 29,285</u>	<u>\$ 42,938</u>	<u>\$ (13,653)</u>	(32) %

- (a) These fees are growing as we continue to grow deposits and open new accounts.
- (b) Mortgage banking revenues were significantly impacted in 2013 by the increase in interest rates. Revenues began to decline mid-year as rates rose. In addition, margins were unusually high in the second quarter of 2012.
- (c) Gains and losses on sales will vary significantly from period to period. The secondary market for SBA loans is currently acquisitive and loans can be sold at attractive prices.
- (d) Gains and losses on sales of securities will vary significantly from period to period.
- (e) In 2013 the Company recorded revenue of \$1.587 million from SBIC investments.
- (f) In the third quarter of 2013 the Company recognized life insurance benefits of \$1.055 million while an insurance settlement of \$7.5 million was recognized in the third quarter of 2012.

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)	
	2013	2012	2013– 2012	
			\$	%
Salaries and employee benefits	\$ 16,668	\$ 17,040	\$ (372)	(2) % (a)
Professional services	3,610	4,665	(1,055)	(23) % (b)
Data processing fees	3,070	2,859	211	7 %
Marketing and promotion	2,708	2,089	619	30 % (c)
Occupancy	2,394	1,935	459	24 % (d)
Regulatory costs	830	1,213	(383)	(32) % (e)
Depreciation and amortization	1,232	1,120	112	10 %
Office supplies and postage	613	684	(71)	(10) %
Other real estate costs	126	2,038	(1,912)	(94) % (f)
Other	3,230	3,822	(592)	(15) %
Subtotal non-interest expense	34,481	37,465	(2,984)	(8) %
Insurance settlement legal fees	-	2,500	(2,500)	(100) % (g)
Impairment charge	1,500	-	1,500	100 % (h)
Total non-interest expense	\$ 35,981	\$ 39,965	\$ (3,984)	(10) %
Efficiency ratio	73.24%	65.08%	8.16%	

- (a) Early in 2013 the Company recognized increased compensation costs relating to mortgage banking and incentive accruals. In the third quarter of 2013 our compensation costs and incentive accruals abated in accordance with our current business. As revenues decreased in response to rising interest rates, the Company reduced operations personnel in mortgage banking in the third quarter of 2013.
- (b) The reduction of professional services is primarily due to the decline in the mortgage production volume.
- (c) Marketing costs have increased for the banking and mortgage banking operations to drive volume.
- (d) Occupancy costs increased in conjunction with facility improvements and office relocations. We consolidated all Minnesota operations in the third quarter of 2013 to one location to ultimately reduce operating costs.
- (e) The decrease is due to lower regulatory assessments.
- (f) Other real estate costs will vary from period to period depending on valuation adjustments on our foreclosed properties— see Note 8. In 2013, costs related to valuation allowances decreased as values of foreclosed properties stabilized coupled with the decrease in other real estate.
- (g) In the prior year we incurred \$2.5 million of legal expenses associated with the insurance settlement that we received in that period.
- (h) In the third quarter we consolidated all Minnesota operations to one location to reduce operating costs and decided to sell a branch building which was underutilized. This resulted in an impairment charge of \$1.5 million to reflect the fair market value of the property.

Income Tax Expense (Benefit)

During 2013, we recorded tax expense of \$3.822 million which resulted in an effective tax rate of 30.70%. The Company is able to carry forward state tax net operating losses aggregating \$6.7 million as of December 31, 2013. The state net operating losses expire between 2014 and 2032.

The Company 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.

Financial Condition

Assets

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

	As of December 31,		Increase (Decrease)	
	2013	2012	2013 – 2012	
			\$	%
Cash and cash equivalents	\$ 18,871	\$ 40,790	\$ (21,919)	(54) % (a)
Investment securities available for sale	435,719	300,549	135,170	45 % (b)
Federal Reserve Bank and Federal Home Loan Bank of Des Moines stock	2,729	2,601	128	5 %
Loans held for sale-mortgage banking	32,870	95,095	(62,225)	(65) % (c)
Loans and leases held for investment, net	308,081	279,378	28,703	10 % (d)
Other real estate, net	1,056	5,131	(4,075)	(79) % (e)
Premises and equipment, net	14,870	15,932	(1,062)	(7) % (f)
Interest receivable	3,554	2,590	964	37 %
Other assets	<u>25,373</u>	<u>28,710</u>	<u>(3,337)</u>	(12) % (g)
Total assets	<u>\$ 843,123</u>	<u>\$ 770,776</u>	<u>\$ 72,347</u>	9 %

- (a) Cash balances can fluctuate significantly, but we generally emphasize liquidity.
- (b) The increase in investments has primarily been funded by deposit growth.
- (c) Loans held for sale declined as production was reduced by the recent increase in interest rates.
- (d) Between 2009 and 2012 we reduced our exposure to credit risk. In 2013, with stable credit quality, we implemented measures to increase our loan portfolio and the end of the period balances exceeded earlier levels.
- (e) Decrease is due to sales of foreclosed assets.
- (f) Premises and equipment decreased due to the transfer of underutilized property to OREO as part of the consolidation in Minnesota.
- (g) Other assets decreased primarily due to reduction in the cash value of insurance policies relating to the life insurance benefits received and a decrease in the fair value of mortgage banking derivatives.

Investment Securities Available for Sale

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

	December 31,			
	2013		2012	
	Amortized cost	Estimated fair market value	Amortized cost	Estimated fair market value
U.S. government agency mortgage-backed securities guaranteed by GNMA	\$ 74,247	\$ 73,466	\$ 60,673	\$ 63,587
U.S. government agency mortgage-backed securities issued by FNMA or FHLMC	32,065	31,678	20,727	20,608
U.S. government agency small business administration pools guaranteed by SBA	47,882	47,824	13,498	13,554
Collateralized mortgage obligations guaranteed by GNMA/VA	141,552	140,557	122,404	123,015
Collateralized mortgage obligations issued by FNMA or FHLMC	77,286	76,629	36,167	36,411
Other collateralized mortgage obligations	1,746	1,794	4,656	4,803
State and municipal bonds	64,733	63,771	35,944	38,571
Total investments	<u>\$ 439,511</u>	<u>\$ 435,719</u>	<u>\$ 294,069</u>	<u>\$ 300,549</u>

There were no securities that management concluded were other-than-temporarily impaired during 2013 or 2012. See Note 4 of our Consolidated Financial Statements.

The following table presents contractual maturities for securities available for sale and yields thereon at December 31, 2013 (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%	\$ 136	7.20%	\$ -	0.00%	\$ 74,111	2.31%	\$ 74,247	2.32%
U.S. government agency mortgage-backed securities issued by FNMA or FHLMC ⁽²⁾⁽³⁾	-	0.00%	-	0.00%	-	0.00%	32,065	1.51%	32,065	1.51%
U.S. government agency small business administration pools guaranteed by SBA ⁽²⁾⁽³⁾	-	0.00%	-	0.00%	2,128	1.52%	45,754	1.00%	47,882	1.02%
Collateralized mortgage obligations guaranteed by GNMA/VA ⁽²⁾⁽³⁾	-	0.00%	-	0.00%	7,596	1.89%	133,956	2.41%	141,552	2.38%
Collateralized mortgage obligations issued by FNMA or FHLMC ⁽²⁾⁽³⁾	-	0.00%	-	0.00%	396	6.46%	76,890	2.58%	77,286	2.60%
Other collateralized mortgage obligations ⁽²⁾⁽³⁾	-	0.00%	-	0.00%	-	0.00%	1,746	5.52%	1,746	5.52%
State and municipal bonds ⁽²⁾	-	0.00%	-	0.00%	2,214	8.05%	62,519	5.14%	64,733	5.24%
Total book value of investment securities	<u>\$ -</u>	<u>0.00%</u>	<u>\$ 136</u>	<u>7.20%</u>	<u>\$ 12,334</u>	<u>3.08%</u>	<u>\$ 427,041</u>	<u>2.62%</u>	<u>439,511</u>	<u>2.63%</u>
Unrealized gain (loss) on securities available for sale									<u>(3,792)</u>	
Total investment in securities available for sale									<u>\$ 435,719</u>	<u>2.65%</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, 2013, we had \$435.7 million of available-for-sale securities in the investment portfolio compared to \$300.5 million at December 31, 2012.

In 2013, available-for-sale investment securities increased as we have deployed cash and funds from new deposits. The net unrealized gain (loss) of investment securities decreased as of December 31, 2013 as compared to December 31, 2012 due to the general increase in interest rates and steepening of the yield curve since the middle of the second quarter 2013.

In 2012, investment securities increased as we have deployed funds from new deposits. 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.

At December 31, 2013, 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 4 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, 2013 and 2012, and \$922 thousand and \$795 thousand of FHLB of Des Moines stock as of December 31, 2013 and 2012, respectively.

Loans

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

	2013		2012		2011		2010		2009	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Loans held for sale-mortgage banking	\$ 32,870	100.0	\$ 95,095	100.0	\$ 68,622	100.0	\$ 29,116	29.2	\$ 24,130	100.0
Other loans held for sale	-	-	-	-	-	-	70,501	70.8	-	-
Loans held for sale, net	<u>32,870</u>	<u>100.0</u>	<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>
Commercial and industrial	132,983	41.8	116,891	40.4	109,746	37.4	120,620	34.4	225,470	43.6
Commercial real estate	93,330	29.3	87,258	30.1	115,704	39.4	152,287	43.4	152,194	29.4
SBA	18,215	5.7	15,823	5.5	9,958	3.4	11,064	3.2	9,260	1.8
Consumer	32,612	10.3	26,614	9.2	23,038	7.9	25,841	7.4	34,439	6.7
Land and land development	27,582	8.7	31,065	10.7	29,350	10.0	37,761	10.8	73,530	14.2
Construction	<u>13,286</u>	<u>4.2</u>	<u>11,814</u>	<u>4.1</u>	<u>5,545</u>	<u>1.9</u>	<u>3,225</u>	<u>0.9</u>	<u>22,797</u>	<u>4.4</u>
	<u>318,008</u>	<u>100.0</u>	<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>
Unearned income and net unamortized deferred (fees) and costs	<u>(80)</u>	<u>-</u>	<u>4</u>	<u>-</u>	<u>(130)</u>	<u>-</u>	<u>(297)</u>	<u>(0.1)</u>	<u>(582)</u>	<u>(0.1)</u>
Loans, net of unearned income and unamortized fees and costs	<u>\$ 317,928</u>	<u>100.0</u>	<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>

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

	December 31,		Increase (Decrease)	
	2013	2012	2013 - 2012	
	\$	\$	\$	%
Loans held for sale-mortgage banking	<u>\$ 32,870</u>	<u>\$ 95,095</u>	<u>\$ (62,225)</u>	(65.4) % (a)
Commercial and industrial	132,983	116,891	16,092	13.8 % (b)
Commercial real estate	93,330	87,258	6,072	7.0 % (b)
SBA	18,215	15,823	2,392	15.1 % (b)
Consumer	32,612	26,614	5,998	22.5 % (b)
Land and land development	27,582	31,065	(3,483)	(11.2) % (b)
Construction	<u>13,286</u>	<u>11,814</u>	<u>1,472</u>	12.5 %
	<u>318,008</u>	<u>289,465</u>	<u>28,543</u>	9.9 %
Unearned income and net unamortized deferred fees and costs	<u>(80)</u>	<u>4</u>	<u>(84)</u>	(2,100.0) %
Loans, net of unearned income and unamortized fees and costs	<u>\$ 317,928</u>	<u>\$ 289,469</u>	<u>\$ 28,459</u>	9.8 %

(a) Loans held for sale declined as production was reduced by the recent increase in interest rates.

(b) Between 2009 and 2012 we reduced our exposure to credit risk. In 2013 we implemented measures to increase our loan portfolio.

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):

2013	\$	222,765
2012		218,068
2011		220,177
2010		259,939
2009		330,204

Concentrations of Credit

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

	<u>2013</u>		<u>2012</u>	
North Dakota	\$ 206,315	65 %	\$ 176,653	61 %
Minnesota	32,198	10	38,188	13
Arizona	34,043	11	29,238	10
Other	<u>45,452</u>	<u>14</u>	<u>45,386</u>	<u>16</u>
Total gross loans held for investment	<u>\$ 318,008</u>	<u>100 %</u>	<u>\$ 289,465</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):

	<u>2013</u>		<u>2012</u>	
North Dakota	\$ 211,789	67%	\$ 168,198	58%
Arizona	43,750	14	40,215	14
California	18,314	6	22,088	8
Minnesota	16,372	5	17,561	6
Colorado	9,164	3	7,686	3
Wisconsin	5,787	2	6,489	2
Other	<u>12,832</u>	<u>3</u>	<u>27,228</u>	<u>9</u>
Total gross loans held for investment	<u>\$ 318,008</u>	<u>100 %</u>	<u>\$ 289,465</u>	<u>100 %</u>

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

	<u>2013</u>	<u>2012</u>
	Total Loans and Leases Held for Investment	Total Loans and Leases Held for Investment
North Dakota		
Commercial and industrial	\$ 73,277	\$ 65,793
Construction	13,082	10,824
Agricultural	16,847	15,047
Land and land development	10,611	12,240
Owner-occupied commercial real estate	28,435	24,107
Commercial real estate	35,654	12,644
Small business administration	2,188	2,428
Consumer	31,695	25,115
Subtotal	<u>\$ 211,789</u>	<u>\$ 168,198</u>
Arizona		
Commercial and industrial	\$ 3,021	\$ 1,421
Construction	-	-
Agricultural	-	-
Land and land development	5,102	5,663
Owner-occupied commercial real estate	1,571	667
Commercial real estate	16,306	16,699
Small business administration	15,502	12,881
Consumer	2,248	2,884
Subtotal	<u>\$ 43,750</u>	<u>\$ 40,215</u>
Minnesota		
Commercial and industrial	\$ 794	\$ 1,154
Construction	-	-
Agricultural	21	24
Land and land development	578	1,145
Owner-occupied commercial real estate	-	-
Commercial real estate	15,589	14,767
Small business administration	91	62
Consumer	1,241	409
Subtotal	<u>\$ 18,314</u>	<u>\$ 17,561</u>

Loan Maturities⁽¹⁾

The following table sets forth the remaining maturities of loans in our portfolio as of December 31, 2013 (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	\$ 50,807	\$ 36,885	\$ 17,434	\$ 18,107	\$ 9,750	\$ 132,983
Commercial real estate	13,225	10,266	13,031	14,452	42,356	93,330
SBA	1,087	185	1,332	1,257	14,354	18,215
Consumer	3,579	18,733	3,573	6,234	493	32,612
Land and land development	9,321	5,037	9,332	3,892	-	27,582
Construction	2,544	-	266	3,056	7,420	13,286
Total principal amount of loans	<u>\$ 80,563</u>	<u>\$ 71,106</u>	<u>\$ 44,968</u>	<u>\$ 46,998</u>	<u>\$ 74,373</u>	<u>\$ 318,008</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, 2013 was \$700 thousand as compared to \$100 thousand in 2012. The provision for credit losses continues to remain low due to credit quality stabilization.

Allowance for Credit Losses

See Notes 1 and 7 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,				
	2013	2012	2011	2010	2009
Balance of allowance for credit losses, beginning of period	\$ 10,091	\$ 10,630	\$ 14,765	\$ 18,047	\$ 8,751
Charge-offs:					
Commercial and industrial	(916)	(70)	(83)	(3,112)	(6,408)
Commercial real estate	(87)	(767)	(4,549)	(283)	(1,993)
SBA	-	(10)	(105)	(620)	-
Consumer	(106)	(58)	(1,049)	(533)	(394)
Land and land development	-	-	(731)	(3,238)	(9,081)
Construction	-	-	-	-	-
Total charge-offs	<u>(1,109)</u>	<u>(905)</u>	<u>(6,517)</u>	<u>(7,786)</u>	<u>(17,876)</u>
Recoveries:					
Commercial and industrial	69	11	49	14	12
Commercial real estate	8	38	506	-	-
SBA	2	12	21	5	-
Consumer	15	18	34	319	11
Land and land development	71	187	67	127	149
Construction	-	-	-	-	-
Total recoveries	<u>165</u>	<u>266</u>	<u>677</u>	<u>465</u>	<u>172</u>
Net charge-offs	(944)	(639)	(5,840)	(7,321)	(17,704)
Provision for credit losses charged to operations	<u>700</u>	<u>100</u>	<u>1,625</u>	<u>5,750</u>	<u>27,000</u>
	9,847	10,091	10,550	16,476	18,047
Transferred (to) from other loans held for sale	-	-	80	(1,711)	-
Balance of allowance for credit losses, end of period	<u>\$ 9,847</u>	<u>\$ 10,091</u>	<u>\$ 10,630</u>	<u>\$ 14,765</u>	<u>\$ 18,047</u>
Ratio of net charge-offs to average total loans	(0.277)%	(0.182)%	(1.611)%	(1.387)%	(2.948)%
Ratio of net charge-offs to average loans and leases held for investment	(0.332)%	(0.225)%	(1.780)%	(1.530)%	(3.235)%
Average gross loans and leases held for investment	\$ 284,344	\$ 284,507	\$ 328,091	\$ 478,492	\$ 547,336
Ratio of allowance for credit losses to loans and leases held for investment	3.10%	3.49%	3.63%	4.21%	3.49%
Ratio of allowance for credit losses to total nonperforming loans	175%	96%	172%	83%	50%
Allowance for credit losses to total loans	2.81%	2.62%	2.94%	3.84%	3.11%
Ratio of nonperforming loans to total assets	0.67%	1.36%	0.93%	2.39%	4.13%

In 2013, the level of nonperforming loans stabilized at \$5.6 million, compared to \$10.5 million at December 31, 2012. At December 31, 2012, nonperforming loans included a lending relationship with a balance of approximately \$5.8 million that is involved with bankruptcy proceedings. In the fourth quarter of 2013 the same lending relationship transferred back to performing status.

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

	2013		2012		2011		2010		2009	
	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	\$ 2,215	42%	\$ 2,546	40%	\$ 1,639	37%	\$ 1,362	34%	\$ 7,440	44%
Commercial real estate	4,041	29%	4,790	30%	5,518	40%	9,818	44%	4,494	29%
SBA	579	6%	616	6%	436	3%	407	3%	260	2%
Consumer	478	10%	382	9%	448	8%	1,182	7%	1,162	7%
Land and land development	2,371	9%	1,609	11%	2,532	10%	1,939	11%	3,849	14%
Construction	163	4%	148	4%	57	2%	57	1%	842	4%
Total	<u>\$ 9,847</u>	<u>100%</u>	<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>

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, 2013 and December 31, 2012. 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,				
	2013	2012	2011	2010	2009
Nonperforming loans:					
Loans 90 days or more delinquent and still accruing interest	\$ 961	\$ 12	\$ -	\$ -	\$ 1
Non-accrual loans	4,656	10,500	6,169	17,862	35,889
Total nonperforming loans	5,617	10,512	6,169	17,862	35,890
Other real estate, net	1,056	5,131	10,145	12,706	7,253
Total nonperforming assets	\$ 6,673	\$ 15,643	\$ 16,314	\$ 30,568	\$ 43,143
Allowance for credit losses	\$ 9,847	\$ 10,091	\$ 10,630	\$ 14,765	\$ 18,047
Ratio of total nonperforming loans to total loans	1.60%	2.73%	1.70%	3.93%	6.19%
Ratio of total nonperforming loans to loans and leases held for investment	1.77%	3.63%	2.10%	5.10%	6.94%
Ratio of total nonperforming assets to total assets	0.79%	2.03%	2.45%	4.09%	4.97%
Ratio of nonperforming loans to total assets	0.67%	1.36%	0.93%	2.39%	4.13%
Ratio of allowance for credit losses to total nonperforming loans	175%	96%	172%	83%	50%

Nonperforming Loans

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

	2013	2012
Balance, beginning of period	\$ 10,512	\$ 6,169
Additions to nonperforming	2,231	5,880
Charge-offs	(935)	(354)
Reclassified back to performing	(5,830)	(815)
Principal payments received	(337)	(368)
Transferred to other real estate	(24)	-
Balance, end of period	\$ 5,617	\$ 10,512

At December 31, 2012, nonperforming loans include one lending relationship with a balance of approximately \$5.8 million that was involved with bankruptcy proceedings. In the fourth quarter of 2013 the same lending relationship transferred back to performing status.

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):

	2013	2012
Interest income that would have been recorded	\$ 848	\$ 919
Interest income recorded	223	329
Effect on interest income	\$ 625	\$ 590

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>
2013	\$ 8,544	\$ 4,356	\$ 4,188
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

See Note 7 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, and property transferred from premises and equipment. 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 8 of our Consolidated Financial Statements for information on other real estate owned.

Impaired loans

See Note 7 of our Consolidated Financial Statements for information on impaired loans.

Potential Problem Loans

In recent years, the macroeconomic environment has been very challenging and asset values were declining throughout most of the country. In 2013, we have continued to assess our existing portfolio for 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 \$176,000 and \$5.2 million at December 31, 2013 and 2012, respectively. Also, we estimate there are loans risk rated "substandard" which are not impaired aggregating \$8.1 million and \$3.1 million at December 31, 2013 and 2012, 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)	
	2013	2012	2013 – 2012	
			\$	%
Deposits:				
Non-interest-bearing	\$ 141,788	\$ 131,593	\$ 10,195	8 % (a)
Interest-bearing-				
Savings, interest checking and money market	378,355	313,051	65,304	21 % (a)
Time deposits under \$100,000	123,058	128,150	(5,092)	(4) % (a)
Time deposits \$100,000 and over	80,028	76,810	3,218	4 % (a)
Short-term borrowings	19,967	11,700	8,267	71 % (b)
Guaranteed preferred beneficial interests in Company's subordinated debentures	22,432	22,430	2	- %
Accrued interest payable	771	5,045	(4,274)	(85) % (c)
Accrued expenses	6,307	10,144	(3,837)	(38) % (c)
Other liabilities	552	3,123	(2,571)	(82) % (d)
Total liabilities	<u>773,258</u>	<u>702,046</u>	<u>71,212</u>	10 %
Stockholders' equity	<u>69,865</u>	<u>68,730</u>	<u>1,135</u>	2 % (e)
Total liabilities and stockholders' equity	<u>\$ 843,123</u>	<u>\$ 770,776</u>	<u>\$ 72,347</u>	9 %

- (a) Total deposits have increased primarily due to growth in our North Dakota branches.
- (b) Short term borrowings will vary depending on our customers need to use repurchase agreements.
- (c) Accrued expenses and interest payable decreased due to payments made on interest and dividend obligations that were deferred until the first quarter of 2013.
- (d) Other liabilities decreased due to a reduction in the fair value of mortgage banking derivatives.
- (e) 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 \$1.7 million and \$1.5 million at December 31, 2013 and 2012, 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. Repurchase risk is also evident within the mortgage banking industry as continued disputes arise between lenders and investors. Such requests for repurchase are commonly requested due to fraudulent or faulty representation and generally emerge at varied timeframes subsequent to the original sale of the loan. 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. See Note 18 of our Consolidated Financial Statements for a description of financial instruments with off-balance-sheet risk.

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,								
	2013			2012			2011		
	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	\$ 341,128	49.68%	0.17%	\$ 271,089	44.81%	0.24%	\$ 253,054	42.13%	0.37%
Savings deposits	19,857	2.89%	0.08%	15,549	2.57%	0.10%	12,655	2.11%	0.10%
Time deposits (CDs):									
CDs under \$100,000	125,641	18.30%	1.22%	127,446	21.06%	1.86%	139,254	23.19%	2.02%
CDs \$100,000 and over	81,196	11.83%	0.66%	65,563	10.84%	1.26%	71,432	11.89%	1.41%
Total time deposits	206,837	30.12%	1.39%	193,009	31.90%	1.66%	210,686	35.08%	1.81%
Total interest-bearing deposits	567,822	82.70%	0.47%	479,647	79.28%	0.80%	476,395	79.32%	1.00%
Non-interest-bearing demand deposits	118,783	17.30%	-	125,367	20.72%	-	124,208	20.68%	-
Total deposits	\$ 686,605	100.00%	0.39%	\$ 605,014	100.00%	0.64%	\$ 600,603	100.00%	0.79%

Since the middle of 2011, we have returned to growing deposits and throughout 2012 and 2013 we have grown deposits, primarily by capitalizing on economic growth in North Dakota.

Time deposits, in denominations of \$100,000 and over, totaled \$80.0 million at December 31, 2013 as compared to \$76.8 million at December 31, 2012. The following table sets forth the amount and maturities of time deposits of \$100,000 and over as of December 31, 2013 (in thousands):

Maturing in:

3 months or less	\$	27,096
Over 3 months through 6 months		14,026
Over 6 months through 12 months		29,780
Over 12 months		9,126
	\$	<u>80,028</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):

	2013	2012	2011
Short-term borrowings outstanding at period end	\$ 19,967	\$ 11,700	\$ 8,635
Weighted average interest rate at period end	0.17%	0.38%	0.92%
Maximum month end balance during the period	\$ 27,071	\$ 16,949	\$ 21,165
Average borrowings outstanding for the period	\$ 18,948	\$ 13,329	\$ 15,583
Weighted average interest rate for the period	0.22%	0.53%	0.85%

Note 11 of our Consolidated Financial Statements summarizes the general terms of our short-term borrowings outstanding at December 31, 2013 and 2012.

FHLB advances totaled \$0 at December 31, 2013 and 2012, respectively.

Notes 12 and 13 of our Consolidated Financial Statements summarize the general terms of our FHLB advances and other borrowings at December 31, 2013 and 2012.

Guaranteed Preferred Beneficial Interests in Company's Subordinated Debentures

See Note 14 of our Consolidated Financial Statements for a description of the subordinated debentures.

Capital Resources

	2013	2012	2011	2010	2009
Tier 1 leverage (Consolidated)	10.94%	11.17%	7.59%	6.17%	8.58%
Tier 1 risk-based capital (Consolidated)	21.67%	20.49%	13.71%	9.46%	12.32%
Total risk-based capital (Consolidated)	23.15%	22.43%	17.56%	12.89%	14.15%
Tangible common equity (Consolidated)	5.79%	6.21%	3.17%	2.24%	4.23%
Tier 1 leverage (BNC National Bank)	10.06%	10.68%	9.41%	7.53%	8.54%
Tier 1 risk-based capital (BNC National Bank)	20.13%	19.80%	16.95%	11.53%	12.25%
Total risk-based capital (BNC National Bank)	21.40%	21.06%	18.22%	12.80%	13.52%

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.

In July of 2013, the Federal Reserve issued new regulatory capital standards for community banks which incorporate some of the capital requirements addressed in the Basel III framework and begin to be effective January 1, 2015. Although we believe we are compliant with the fully phased in standards, we have not completed our assessment of the proposed standards. The Company routinely evaluates the need to raise capital to comply with regulatory capital standards and for other corporate purposes.

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 18 and 19 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 18 of our Consolidated Financial Statements.

At December 31, 2013, the aggregate contractual obligations (excluding bank deposits) and commitments were as follows (in thousands):

Contractual Obligations:	Payments due by period				Total
	Less than 1 year	1 to 3 years	3 to 5 years	After 5 years	
Total borrowings	\$ 19,967	\$ -	\$ -	\$ 22,432	\$ 42,399
Commitments to sell loans	32,203	-	-	-	32,203
Annual rental commitments under non-cancelable operating leases	790	1,164	577	1,370	3,901
Total	\$ 52,960	\$ 1,164	\$ 577	\$ 23,802	\$ 78,503

Other Commitments:	Amount of Commitment - Expiration by Period				Total
	Less than 1 year	1 to 3 years	3 to 5 years	After 5 years	
Commitments to lend	\$ 118,673	\$ 9,470	\$ 5,698	\$ 500	\$ 134,341
Standby and commercial letters of credit	1,438	-	-	-	1,438
Total	\$ 120,111	\$ 9,470	\$ 5,698	\$ 500	\$ 135,779

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 (\$243.6 million as of December 31, 2013);
2. Borrowing capacity from the FHLB (\$58.1 million as of December 31, 2013); and
3. Capacity to issue brokered deposits with maturities of less than 12 months (\$118.5 million as of December 31, 2013).

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.

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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, 2013 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, 2013 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, 2013, 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 2014 is shown below:

Net Interest Income Simulation

Movement in interest rates	-100bp	Unchanged	+100bp	+200bp	+300bp	+400bp
Projected 12-month net interest income	\$ 23,046	\$ 23,997	\$ 23,845	\$ 23,609	\$ 23,320	\$ 22,921
Dollar change from unchanged scenario	\$ (951)	-	\$ (152)	\$ (388)	\$ (677)	\$ (1,076)
Percentage change from unchanged scenario	(3.96)%	-	(0.63)%	(1.62)%	(2.82)%	(4.48)%

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, 2013 (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, 2013. 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, 2013				
	0-3 months	4-12 months	1-5 years	Over 5 years	Total
Interest-earning assets:					
Interest-bearing deposits with banks	\$ 18,871	\$ -	\$ -	\$ -	\$ 18,871
Investment securities (a)	52,465	39,940	137,652	183,252	413,309
FRB and FHLB stock	2,729	-	-	-	2,729
Fed Funds Sold	-	-	-	-	-
Loans held for sale-mortgage banking, fixed rate	-	32,870	-	-	32,870
Loans held for sale-mortgage banking, floating rate	-	-	-	-	-
Loans held for investment, fixed rate	19,622	41,717	61,529	29,068	151,936
Loans held for investment, floating rate	104,567	6,460	42,072	12,893	165,992
Total interest-earning assets	<u>\$ 198,254</u>	<u>\$ 120,987</u>	<u>\$ 241,253</u>	<u>\$ 225,213</u>	<u>\$ 785,707</u>
Interest-bearing liabilities:					
Interest checking and money market accounts	\$ 356,286	\$ -	\$ -	\$ -	\$ 356,286
Savings	22,069	-	-	-	22,069
Time deposits under \$100,000	12,814	31,305	49,067	29,872	123,058
Time deposits \$100,000 and over	27,096	43,806	9,126	-	80,028
Short-term borrowings	19,967	-	-	-	19,967
FHLB advances	-	-	-	-	-
Other borrowings	-	-	-	-	-
Subordinated debentures	15,000	-	-	7,432	22,432
Total interest-bearing liabilities	<u>\$ 453,232</u>	<u>\$ 75,111</u>	<u>\$ 58,193</u>	<u>\$ 37,304</u>	<u>\$ 623,840</u>
Interest rate gap	<u>\$ (254,978)</u>	<u>\$ 45,876</u>	<u>\$ 183,060</u>	<u>\$ 187,909</u>	<u>\$ 161,867</u>
Cumulative interest rate gap at December 31, 2013	<u>\$ (254,978)</u>	<u>\$ (209,102)</u>	<u>\$ (26,042)</u>	<u>\$ 161,867</u>	
Cumulative interest rate gap to total assets	(30.24)%	(24.80)%	(3.09)%	19.20%	

(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, 2013 and do not contemplate any actions we might undertake in response to changes in market interest rates.

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KPMG LLP
Suite 300
1212 N. 96th Street
Omaha, NE 68114-2274

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, 2013 and 2012, 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 audit 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, 2013 and 2012, and the results of their operations and their cash flows for the years then ended, in accordance with U.S. generally accepted accounting principles.

/s/ KPMG LLP

Omaha, Nebraska
March 18, 2014

FINANCIAL INFORMATION

Financial Statements

BNCCORP, INC. AND SUBSIDIARIES

Consolidated Balance Sheets

As of December 31

(In thousands, except share data)

ASSETS	2013	2012
CASH AND CASH EQUIVALENTS	\$ 18,871	\$ 40,790
INVESTMENT SECURITIES AVAILABLE FOR SALE	435,719	300,549
FEDERAL RESERVE BANK AND FEDERAL HOME LOAN BANK STOCK	2,729	2,601
LOANS HELD FOR SALE-MORTGAGE BANKING	32,870	95,095
LOANS AND LEASES HELD FOR INVESTMENT	317,928	289,469
ALLOWANCE FOR CREDIT LOSSES	(9,847)	(10,091)
Net loans and leases held for investment	308,081	279,378
OTHER REAL ESTATE, net	1,056	5,131
PREMISES AND EQUIPMENT, net	14,870	15,932
ACCRUED INTEREST RECEIVABLE	3,554	2,590
OTHER ASSETS	25,373	28,710
Total assets	<u>\$ 843,123</u>	<u>\$ 770,776</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
DEPOSITS:		
Non-interest-bearing	\$ 141,788	\$ 131,593
Interest-bearing –		
Savings, interest checking and money market	378,355	313,051
Time deposits under \$100,000	123,058	128,150
Time deposits \$100,000 and over	80,028	76,810
Total deposits	723,229	649,604
SHORT-TERM BORROWINGS	19,967	11,700
GUARANTEED PREFERRED BENEFICIAL INTERESTS IN COMPANY'S SUBORDINATED DEBENTURES	22,432	22,430
ACCRUED INTEREST PAYABLE	771	5,045
ACCRUED EXPENSES	6,307	10,144
OTHER LIABILITIES	552	3,123
Total liabilities	773,258	702,046
STOCKHOLDERS' EQUITY:		
Preferred stock, \$.01 par value – Authorized 2,000,000 shares:		
Preferred Stock - 5% Series A 20,093 shares outstanding;	20,093	19,859
Preferred Stock - 9% Series B 1,005 shares outstanding;	1,005	1,029
Common stock, \$.01 par value – Authorized 35,000,000 shares; 3,374,601 and 3,300,652 shares issued and outstanding	34	33
Capital surplus – common stock	26,133	27,257
Retained earnings	27,962	20,655
Treasury stock (294,052 and 368,001 shares, respectively)	(3,894)	(5,064)
Accumulated other comprehensive income (loss), net	(1,468)	4,961
Total stockholders' equity	69,865	68,730
Total liabilities and stockholders' equity	<u>\$ 843,123</u>	<u>\$ 770,776</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>2013</u>	<u>2012</u>
INTEREST INCOME:		
Interest and fees on loans	\$ 16,118	\$ 16,750
Interest and dividends on investments -		
Taxable	5,979	6,162
Tax-exempt	1,496	967
Dividends	113	113
Total interest income	<u>23,706</u>	<u>23,992</u>
INTEREST EXPENSE:		
Deposits	2,660	3,857
Short-term borrowings	41	71
Subordinated debentures	1,160	1,593
Total interest expense	<u>3,861</u>	<u>5,521</u>
Net interest income	19,845	18,471
PROVISION FOR CREDIT LOSSES	700	100
NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES	<u>19,145</u>	<u>18,371</u>
NON-INTEREST INCOME:		
Bank charges and service fees	2,675	2,492
Wealth management revenues	1,260	1,204
Mortgage banking revenues	19,344	29,658
Gains on sales of loans, net	1,632	1,110
Gains on sales of securities, net	1,247	279
Other	2,072	695
Insurance claim settlement	-	7,500
Life insurance benefit received	1,055	-
Total non-interest income	<u>29,285</u>	<u>42,938</u>
NON-INTEREST EXPENSE:		
Salaries and employee benefits	16,668	17,040
Professional services	3,610	4,665
Data processing fees	3,070	2,859
Marketing and promotion	2,708	2,089
Occupancy	2,394	1,935
Regulatory costs	830	1,213
Depreciation and amortization	1,232	1,120
Office supplies and postage	613	684
Other real estate costs	126	2,038
Other	3,230	3,822
Insurance settlement legal fees	-	2,500
Impairment charge	1,500	-
Total non-interest expense	<u>35,981</u>	<u>39,965</u>
Income before income taxes	12,449	21,344
Income tax expense (benefit)	3,822	(5,280)
Net income	\$ 8,627	\$ 26,624
Preferred stock costs	(1,320)	(1,462)
Net income available to common shareholders	<u>\$ 7,307</u>	<u>\$ 25,162</u>
Basic income per common share	<u>\$ 2.22</u>	<u>\$ 7.64</u>
Diluted income per common share	<u>\$ 2.11</u>	<u>\$ 7.52</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)

	2013		2012	
NET INCOME	\$	8,627	\$	26,624
Unrealized gain (loss) on securities available for sale	\$	(9,025)	\$	2,614
Reclassification adjustment for gain included in net income		(1,247)		(279)
Other comprehensive (loss) income, before tax		(10,272)		2,335
Income tax benefit (expense) related to items of other comprehensive income		3,843		(888)
Other comprehensive (loss) income		(6,429)		1,447
TOTAL COMPREHENSIVE INCOME	\$	2,198	\$	28,071

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	Earnings		Other	
					Common	(Deficit)		Comprehensive	
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
Net income	-	-	-	-	-	8,627	-	-	8,627
Other comprehensive loss	-	-	-	-	-	-	-	(6,429)	(6,429)
Preferred stock amortization, net	-	210	-	-	-	(210)	-	-	-
Accrued dividend on preferred stock	-	-	-	-	-	(1,110)	-	-	(1,110)
Impact of share-based compensation	-	-	73,949	1	(1,124)	-	1,170	-	47
BALANCE, December 31, 2013	21,098	\$ 21,098	3,374,601	\$ 34	\$ 26,133	\$ 27,962	\$ (3,894)	\$ (1,468)	\$ 69,865

See accompanying notes to consolidated financial statements

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

	2013	2012
OPERATING ACTIVITIES:		
Net income	\$ 8,627	\$ \$ 26,624
Adjustments to reconcile net income to net cash provided by (used in) operating activities -		
Provision for credit losses	700	100
(Recovery) provision for other real estate losses	(14)	1,700
Depreciation and amortization	1,232	1,120
Net amortization of premiums and (discounts)	8,259	5,510
Share-based compensation	47	52
Change in interest receivable and other assets, net	(44)	2,358
Loss on disposals of bank premises and equipment, net	118	17
(Gain) loss on sale of other real estate	(8)	108
Net realized gain on sales of investment securities	(1,247)	(279)
Benefit for deferred income taxes	(536)	(4,743)
Change in other liabilities, net	(4,650)	189
Gains on sales of loans, net	(1,632)	(1,110)
Change in fair value on mortgage banking derivatives	3,519	(4,923)
Proceeds from sales of loans	16,132	12,141
Funding of originations of loans held for sale	(947,823)	(1,168,092)
Proceeds from sales of loans held for sale	1,007,926	1,142,126
Fair value adjustment for loans held for sale	2,122	(650)
Net cash provided by operating activities	92,728	12,248
INVESTING ACTIVITIES:		
Purchases of investment securities	(269,235)	(113,244)
Proceeds from sales of investment securities	58,109	8,853
Proceeds from maturities of investment securities	61,135	42,688
Purchases of Federal Reserve and Federal Home Loan Bank Stock	(129)	(481)
Sales of Federal Reserve and Federal Home Loan Bank Stock	1	630
Net increase in loans held for investment	(43,903)	(7,786)
Proceeds from sales of other real estate	4,898	3,206
Additions to bank premises and equipment	(2,748)	(1,042)
Proceeds from sales of bank premises and equipment	14	8
Net cash used in investing activities	(191,858)	(67,168)

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)

	2013	2012
FINANCING ACTIVITIES:		
Net increase in deposits	73,625	73,349
Net increase in short-term borrowings	8,267	3,065
Repayments of Federal Home Loan Bank advances	(20)	(10,810)
Proceeds from Federal Home Loan Bank advances	20	10,810
Dividends paid on preferred stock	(4,681)	-
Net cash provided by financing activities	77,211	76,414
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(21,919)	21,494
CASH AND CASH EQUIVALENTS, beginning of year	40,790	19,296
CASH AND CASH EQUIVALENTS, end of year	\$ 18,871	\$ 40,790
SUPPLEMENTAL CASH FLOW INFORMATION:		
Interest paid	\$ 8,135	\$ 4,086
Income taxes paid	\$ 1,748	\$ 707
 SUPPLEMENTAL DISCLOSURE OF NONCASH INVESTING AND FINANCING ACTIVITIES:		
Transfer of premises and equipment to other real estate owned	\$ 800	\$ -

See accompanying 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 North Dakota, Arizona and Minnesota from 14 locations. The Bank also conducts mortgage banking from 10 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), fair value of investments, impairments and income taxes. 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 restructured 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 where allowed.

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 follows the guidance on other-than-temporary impairments Accounting Standards Codification (ASC) 320, *Investments-Debt and Equity Securities*. 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 4 to these consolidated financial statements includes a summary of investment securities in a loss position at December 31, 2013 and 2012.

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, 2013 and 2012, 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, 2013 or 2012.

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 recorded at 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 impairment charges of \$1.5 million and \$0 in 2013 and 2012, respectively.

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 22 to these consolidated financial statements includes disclosure of the Company's EPS calculations.

Comprehensive Income (Loss)

Comprehensive income (loss) is the total of net income and accumulated other comprehensive income (loss), 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, 2013, the Company had four stock-based employee compensation plans, which are described more fully in Note 25 to these consolidated financial statements.

RECENTLY ISSUED OR ADOPTED ACCOUNTING PRONOUNCEMENTS

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 identifying 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 7 in the Company's notes to the 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 changed 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 the Company, this ASU was 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. The adoption of this ASU in 2013 did not have a material impact on the Company's consolidated financial statements.

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 were asked to review and provide comments to the FASB on the proposal by May 31, 2013.

In February 2013, the FASB issued ASU 2013-02, *Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*. This update requires entities to provide information about the amounts reclassified out of accumulated other comprehensive income by component. In addition, entities are required to present, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income. This ASU is effective for fiscal years and interim periods beginning after December 15, 2013 for non-public companies. The adoption of this ASU in 2014 is not anticipated to have a material impact on the Company's consolidated financial statements.

In July 2013, the FASB issued ASU No. 2013-10, *Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a Benchmark Interest Rate for Hedge Accounting Purposes* (a consensus of the FASB Emerging Issues Task Force), which permits the use of the Fed Funds Effective Swap Rate (also referred to as the Overnight Index Swap Rate), in addition to the U.S. government rate (UST) and London Interbank Offered Rate (LIBOR), as a U.S. benchmark interest rate for hedge accounting purposes under FASB ASC Topic 815, *Derivatives and Hedging*. Entities should apply the ASU prospectively for qualifying new or redesignated hedging relationships entered into on or after July 17, 2013. The adoption of this ASU did not have a material impact on the Company's consolidated financial statements.

In July 2013, the FASB issued ASU No. 2013-11, *Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists* (a consensus of the FASB Emerging Issues Task Force), which requires an entity to present an unrecognized tax benefit as a reduction of a deferred tax asset for a net operating loss (NOL) carryforward, or similar tax loss or tax credit carryforward, rather than as a liability when (1) the uncertain tax position would reduce the NOL or other carryforward under the tax law of the applicable jurisdiction and (2) the entity intends to use the deferred tax asset for that purpose. The ASU does not require new recurring disclosures. It is effective prospectively for fiscal years, and interim periods within those years, beginning after December 15, 2013 and December 15, 2014, for public and nonpublic entities, respectively. Early adoption and retrospective application are permitted. The adoption of this ASU in 2014 is not anticipated to have a material impact on the Company's consolidated financial statements.

In December 2011, the FASB issued ASU 2011-11, *Disclosures about Offsetting Assets and Liabilities*. The ASU is a joint requirement by the FASB and International Accounting Standards Board to enhance current disclosures and increase comparability of GAAP and International Financial Reporting Standards financial statements. Under

the ASU, an entity will be required to disclose both gross and net information about instruments and transactions eligible for offset in the balance sheet, as well as instruments and transactions subject to an agreement similar to a master netting agreement. The scope of the ASU includes derivatives, sale and repurchase agreements, reverse sale and repurchase agreements, and securities borrowing and securities lending arrangements. The ASU was effective for annual and interim periods beginning January 1, 2013. Adoption of the ASU did not have a material effect on the Company's consolidated financial statements.

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
2013								
Total Capital (to risk-weighted assets):								
Consolidated	\$ 97,354	23.15 %	\$ 33,644	≥8.0 %	\$ N/A	N/A %	\$ N/A	N/A %
BNC National Bank	88,922	21.40	33,245	≥8.0	41,556	10.0	47,366	11.40
Tier 1 Capital (to risk-weighted assets):								
Consolidated	91,150	21.67	16,822	≥4.0	N/A	N/A	N/A	N/A
BNC National Bank	83,670	20.13	16,622	≥4.0	24,934	6.0	58,736	14.13
Tier 1 Capital (to average assets):								
Consolidated	91,150	10.94	33,316	≥4.0	N/A	N/A	N/A	N/A
BNC National Bank	83,670	10.06	33,271	≥4.0	41,589	5.0	42,081	5.06
Tangible Equity (to total assets):								
Consolidated tangible equity	69,800	8.30	N/A	N/A	N/A	N/A	N/A	N/A
BNC National Bank	82,592	9.82	N/A	N/A	N/A	N/A	N/A	N/A
Tangible Common Equity (to total assets):								
Consolidated tangible common equity	48,702	5.79	N/A	N/A	N/A	N/A	N/A	N/A
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

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 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 were \$3.7 million and accrued interest payable on debt was \$4.8 million at December 31, 2012. On February 15, 2013, all accrued dividends and interest were paid and the Company is current on these obligations.

NOTE 3. Fraud Loss on Assets Serviced by Others

In April of 2010, the Company discovered fraudulent activity by an external company that was servicing residential mortgage loans for the Company.

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 4. Investment Securities Available For Sale

Investment securities have been classified in the consolidated balance sheets according to management's intent. The Company had no securities designated as trading or held-to-maturity in its portfolio at December 31, 2013 or 2012. The carrying amount of available-for-sale securities and their approximate fair values were as follows as of December 31 (in thousands):

	2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. government agency mortgage-backed securities guaranteed by GNMA	\$ 74,247	\$ 591	\$ (1,372)	\$ 73,466
U.S. government agency mortgage-backed securities issued by FNMA or FHLMC	32,065	210	(597)	31,678
U.S. government agency small business administration pools guaranteed by SBA	47,882	111	(169)	47,824
Collateralized mortgage obligations guaranteed by GNMA/VA	141,552	968	(1,963)	140,557
Collateralized mortgage obligations issued by FNMA or FHLMC	77,286	514	(1,171)	76,629
Other collateralized mortgage obligations	1,746	48	-	1,794
State and municipal bonds	64,733	521	(1,483)	63,771
	<u>\$ 439,511</u>	<u>\$ 2,963</u>	<u>\$ (6,755)</u>	<u>\$ 435,719</u>
	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>

The amortized cost and estimated fair market value of available-for-sale securities classified according to their contractual maturities at December 31, 2013, were as follows (in thousands):

	Amortized Cost	Estimated Fair Value
Due in one year or less	\$ -	\$ -
Due after one year through five years	136	136
Due after five years through ten years	12,334	12,688
Due after ten years	427,041	422,895
Total	<u>\$ 439,511</u>	<u>\$ 435,719</u>

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

Securities carried at approximately \$71.8 million and \$59.0 million at December 31, 2013 and 2012, 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):

	2013	2012
Sales proceeds	\$ 58,109	\$ 8,853
Gross realized gains	1,759	279
Gross realized losses	(512)	-
Net realized gains	<u>1,247</u>	<u>279</u>

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

Description of Securities	2013								
	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	7	\$ 34,534	\$ (889)	1	\$ 8,891	\$ (483)	8	\$ 43,425	\$ (1,372)
U.S. government agency mortgage-backed securities issued by FNMA or FHLMC	6	27,265	(597)	-	-	-	6	27,265	(597)
U.S. government agency small business administration pools guaranteed by SBA	7	17,741	(169)	-	-	-	7	17,741	(169)
Collateralized mortgage obligations guaranteed by GNMA/VA	13	49,531	(1,478)	4	16,373	(485)	17	65,904	(1,963)
Collateralized mortgage obligations issued by FNMA or FHLMC	6	24,740	(529)	3	14,452	(642)	9	39,192	(1,171)
Other collateralized mortgage obligations	-	-	-	-	-	-	-	-	-
State and municipal bonds	24	46,609	(1,483)	-	-	-	24	46,609	(1,483)
Total temporarily impaired securities	63	\$ 200,420	\$ (5,145)	8	\$ 39,716	\$ (1,610)	71	\$ 240,136	\$ (6,755)
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)

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 2013 or 2012.

NOTE 5. Federal Reserve Bank and Federal Home Loan Bank of Des Moines Stock

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

	<u>2013</u>	<u>2012</u>
Federal Reserve Bank Stock, at cost	\$ 1,807	\$ 1,806
Federal Home Loan Bank of Des Moines Stock, at cost	922	795
Total	<u>\$ 2,729</u>	<u>\$ 2,601</u>

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

NOTE 6. Loans and Leases

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

	<u>2013</u>	<u>2012</u>
Loans held for sale-mortgage banking	\$ 32,870	\$ 95,095
Commercial and industrial	\$ 132,983	\$ 116,891
Commercial real estate	93,330	87,258
SBA	18,215	15,823
Consumer	32,612	26,614
Land and land development	27,582	31,065
Construction	13,286	11,814
	318,008	289,465
Unearned income and net unamortized deferred (fees) and costs	<u>(80)</u>	<u>4</u>
Loans, net of unearned income and unamortized (fees) and costs	317,928	289,469
Allowance for credit losses	<u>(9,847)</u>	<u>(10,091)</u>
Net loans and leases held for investment	<u>\$ 308,081</u>	<u>\$ 279,378</u>

Loans to Related Parties

Note 20 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>2013</u>	<u>2012</u>
Commercial and industrial	\$ 20,922	\$ 20,704
Commercial real estate	51,064	46,991
Consumer	<u>17,181</u>	<u>14,855</u>
	<u>\$ 89,167</u>	<u>\$ 82,550</u>

NOTE 7. Allowance for Credit Losses

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

2013							
	Commercial and industrial	Commercial real estate	SBA	Consumer	Land and land development	Construction	Total
Balance, beginning of period	\$ 2,546	\$ 4,790	\$ 616	\$ 382	\$ 1,609	\$ 148	\$ 10,091
Provision for credit losses	516	(670)	(39)	187	691	15	700
Loans charged off	(916)	(87)	-	(106)	-	-	(1,109)
Loan recoveries	69	8	2	15	71	-	165
Balance, end of period	<u>\$ 2,215</u>	<u>\$ 4,041</u>	<u>\$ 579</u>	<u>\$ 478</u>	<u>\$ 2,371</u>	<u>\$ 163</u>	<u>\$ 9,847</u>

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>

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):

	2013					
	Current	31-89 Days Past Due	90 Days or More Past Due and Accruing	Total Performing	Non-accrual	Total
Commercial and industrial:						
Business loans	\$ 78,137	\$ 88	\$ -	\$ 78,225	\$ -	\$ 78,225
Agriculture	17,499	-	-	17,499	-	17,499
Owner-occupied commercial real estate	36,829	-	-	36,829	430	37,259
Commercial real estate	89,142	-	-	89,142	4,188	93,330
SBA	18,215	-	-	18,215	-	18,215
Consumer:						
Automobile	6,634	17	-	6,651	38	6,689
Home equity	4,292	-	-	4,292	-	4,292
1st mortgage	11,612	-	-	11,612	-	11,612
Other	10,012	7	-	10,019	-	10,019
Land and land development	26,621	-	961	27,582	-	27,582
Construction	13,286	-	-	13,286	-	13,286
Total loans held for investment	312,279	112	961	313,352	4,656	318,008
Loans held for sale	32,870	-	-	32,870	-	32,870
Total gross loans	\$ 345,149	\$ 112	\$ 961	\$ 346,222	\$ 4,656	\$ 350,878

2012

	<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	\$ 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	<u>\$ 373,979</u>	<u>\$ 69</u>	<u>\$ 12</u>	<u>\$ 374,060</u>	<u>\$ 10,500</u>	<u>\$ 384,560</u>

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>2013</u>	<u>2012</u>
Interest income that would have been recorded	\$ 265	\$ 228
Interest income recorded	-	-
Effect on interest income	<u>\$ 265</u>	<u>\$ 228</u>

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, 2013 and 2012 (in thousands):

2013

	<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	\$ -	\$ -	\$ -	\$ -	\$ -
Agriculture	-	-	-	-	-
Owner-occupied commercial real estate	514	430	30	430	-
Commercial real estate	6,857	4,188	1,030	4,347	-
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>\$ 7,371</u>	<u>\$ 4,618</u>	<u>\$ 1,060</u>	<u>\$ 4,777</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	64	38	-	44	-
Home equity	-	-	-	-	-
1st mortgage	-	-	-	-	-
Other	-	-	-	-	-
Land and land development	-	-	-	-	-
Construction	-	-	-	-	-
Loans held for sale	-	-	-	-	-
Total impaired loans without an allowance recorded	<u>\$ 64</u>	<u>\$ 38</u>	<u>\$ -</u>	<u>\$ 44</u>	<u>\$ -</u>
TOTAL IMPAIRED LOANS	<u><u>\$ 7,435</u></u>	<u><u>\$ 4,656</u></u>	<u><u>\$ 1,060</u></u>	<u><u>\$ 4,821</u></u>	<u><u>\$ -</u></u>

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>

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.

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

	2013			
	Accrual	Non-accrual	Total	Allowance
Commercial and industrial:				
Business loans	\$ 93	\$ -	\$ 93	\$ 14
Agriculture	-	-	-	-
Owner-occupied commercial real estate	-	-	-	-
Commercial real estate	3,770	4,188	7,958	1,124
SBA	-	-	-	-
Consumer:				
Automobile	-	-	-	-
Home equity	-	-	-	-
1st mortgage	493	-	493	12
Other	-	-	-	-
Land and land development	-	-	-	-
Construction	-	-	-	-
Loans held for sale	-	-	-	-
	<u>\$ 4,356</u>	<u>\$ 4,188</u>	<u>\$ 8,544</u>	<u>\$ 1,150</u>
	2012			
	Accrual	Non-accrual	Total	Allowance
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>

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. There were no new TDRs for the year ending December 31, 2013 and one new TDR with a pre-modification and post-modification outstanding amount of \$202 thousand for the year ending December 31, 2012.

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>2013</u>	<u>2012</u>
Interest income that would have been recorded	\$ 583	\$ 691
Interest income recorded	<u>223</u>	<u>329</u>
Effect on interest income	<u>\$ 360</u>	<u>\$ 362</u>

The amount of additional funds committed to borrowers who are in TDR status was \$232,000 at December 31, 2013 and \$232,000 at December 31, 2012.

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

As of December 31, 2013 and December 31, 2012, 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 8. Other Real Estate

Other real estate (ORE) includes property acquired through foreclosure, property in judgment and in-substance foreclosures, and property transferred from premises and equipment. 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>2013</u>	<u>2012</u>
Balance, beginning of year	\$ 5,131	\$ 10,145
Transfers from nonperforming loans	-	-
Transfers from premises and equipment	800	-
Real estate sold	(4,897)	(3,206)
Net gains (losses) on sale of assets	8	(108)
Provision	14	(1,700)
Balance, end of year	<u>\$ 1,056</u>	<u>\$ 5,131</u>

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

	<u>2013</u>	<u>2012</u>
Other real estate	\$ 3,250	\$ 8,146
Valuation allowance	(2,194)	(3,015)
Other real estate, net	<u>\$ 1,056</u>	<u>\$ 5,131</u>

NOTE 9. Premises and Equipment, net

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

	<u>2013</u>	<u>2012</u>
Land and improvements	\$ 5,083	\$ 5,220
Buildings and improvements	10,768	11,704
Leasehold improvements	491	655
Furniture, fixtures and equipment	9,391	8,854
Total cost	<u>25,733</u>	<u>26,433</u>
Less accumulated depreciation and amortization	(10,863)	(10,501)
Net premises and equipment	<u>\$ 14,870</u>	<u>\$ 15,932</u>

Depreciation and amortization expense totaled approximately \$1.2 million and \$1.1 million for the years ended December 31, 2013 and 2012, respectively.

NOTE 10. Deposits

The scheduled maturities of time deposits as of December 31, 2013 are as follows (in thousands):

2014	\$	115,021
2015		13,016
2016		14,494
2017		8,588
2018		22,095
Thereafter		29,872
	\$	<u>203,086</u>

At December 31, 2013 and 2012, the Bank had \$64.5 million and \$65.0 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>2013</u>	<u>2012</u>
Savings	\$ 15	\$ 15
Interest checking	134	197
Money market	442	449
Time deposits	<u>2,069</u>	<u>3,196</u>
	<u>\$ 2,660</u>	<u>\$ 3,857</u>

Deposits Received from Related Parties

Note 20 to these consolidated financial statements includes information relating to deposits received from executive officers, directors, principal shareholders and associates of such persons.

NOTE 11. 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>2013</u>	<u>2012</u>
Federal reserve borrowings - U. S. Treasury tax and loan retainer	\$ -	\$ -
Repurchase agreements with customers, renewable daily, interest payable monthly, rates ranging from 0.10% to 0.60% in 2013, and from 0.30% to 1.00% in 2012, secured by government agency collateralized mortgage obligations and general obligations of municipalities	<u>19,967</u>	<u>11,700</u>
	<u>\$ 19,967</u>	<u>\$ 11,700</u>

The weighted average interest rate on short-term borrowings outstanding as of December 31, 2013 and 2012 was 0.17% and 0.38%, 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, 2013, \$20.0 million of securities sold under repurchase agreements, with a weighted average

interest rate of 0.17%, were collateralized by government agency collateralized mortgage obligations and general obligations of municipalities having a market value of \$30.3 million and unamortized principal balances of \$31.3 million. 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 and general obligations of municipalities having a market value of \$22.6 million and unamortized principal balances of \$21.2 million.

NOTE 12. Federal Home Loan Bank Advances

As of December 31, 2013, the Bank had \$0 of FHLB advances outstanding. At December 31, 2013, the Bank has mortgage loans with unamortized principal balances of approximately \$83.1 million and securities with unamortized principal balances of approximately \$2.3 million which were pledged as collateral to the FHLB. The Bank has the ability to draw advances up to approximately \$58.1 million based upon the mortgage loans and securities that are currently pledged, subject to a requirement to purchase additional FHLB stock.

As of December 31, 2012, the Bank had \$0 of FHLB advances outstanding. At December 31, 2012, the Bank had 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.

NOTE 13. Other Borrowings

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

2013				
<u>Unsecured Borrowing Lines:</u>				
	Line	Outstanding	Available	
Bank of North Dakota	\$ 5,000	\$ -	\$ 5,000	
US Bank	10,000	-	10,000	
Zions First National Bank	12,000	-	12,000	
Total	<u>\$ 27,000</u>	<u>\$ -</u>	<u>\$ 27,000</u>	
<u>Secured Borrowing Lines:</u>				
	Collateral Pledged	Line	Outstanding	Available
Bank of North Dakota	\$ 1,397	\$ 1,118	\$ -	\$ 1,118
Total		<u>\$ 1,118</u>	<u>\$ -</u>	<u>\$ 1,118</u>

At December 31, 2013, the pledged collateral was comprised of collateralized mortgage obligations.

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 14. 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, 2013 and 2012 was 1.65% and 1.76%, respectively. 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 a fixed rate of 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.

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 was included in interest payable. The Company brought these obligations current as of January 19, 2013 and we continue to remain current on the obligations.

NOTE 15. 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 February 2014 and thereafter pays a dividend of 9%. There were 20,093 shares of this series outstanding as of December 31, 2013 and 2012. 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, 2013 and 2012.

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 had recorded the accrued dividends aggregating \$3.7 million which was included in other liabilities in the consolidated financial statements. On February 15, 2013, all accrued dividends and interest were paid and the Company is current on CPP obligations.

The U.S. Department of the Treasury successfully auctioned BNCCORP's preferred stock and transferred ownership to private investors effective March 17, 2014.

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 16. 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, 2013				Twelve Months Ended December 31, 2013
	Total	Level 1	Level 2	Level 3	Total gains/(losses)
ASSETS					
Securities available for sale	\$ 435,719	\$ -	\$ 435,719	\$ -	\$ 1,247
Loans held for sale	32,870	-	32,870	-	(2,032)
Commitments to originate mortgage loans	706	-	706	-	(4,153)
Commitments to sell mortgage loans	107	-	107	-	2,341
Mortgage banking short positions	274	-	274	-	326
Total assets at fair value	<u>\$ 469,676</u>	<u>\$ -</u>	<u>\$ 469,676</u>	<u>\$ -</u>	<u>\$ (2,271)</u>

LIABILITIES

Commitments to sell mortgage loans	\$ -	\$ -	\$ -	\$ -	\$ -
Mortgage banking short positions	-	-	-	-	-
Total liabilities at fair value	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>

	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>

Historically, the Company has delivered loans on a best efforts delivery basis. In 2012, 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 and sell mortgage banking loans and our short positions are derivatives and are recorded at fair value.

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):

2013					
	Total	Level 1	Level 2	Level 3	Total gains/ (losses)
Impaired loans ⁽¹⁾	\$ 3,596	\$ -	\$ 3,596	\$ -	\$ 140
Other real estate ⁽²⁾	1,056	-	1,056	-	22
Total	\$ 4,652	\$ -	\$ 4,652	\$ -	\$ 162

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)

(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 17. 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	2013		2012	
		Carrying Amount	Fair Value	Carrying Amount	Fair Value
Assets:					
Cash and cash equivalents	Level 1	\$ 18,871	\$ 18,871	\$ 40,790	\$ 40,790
Investment securities available for sale	Level 2	435,719	435,719	300,549	300,549
Federal Reserve Bank and Federal Home Loan Bank stock	Level 2	2,729	2,729	2,601	2,601
Loans held for sale-mortgage banking	Level 2	32,870	32,870	95,095	95,095
Commitments to originate mortgage loans	Level 2	706	706	4,499	4,499
Commitments to sell mortgage loans	Level 2	107	107	-	-
Mortgage banking short positions	Level 2	274	274	-	-
Loans and leases held for investment, net	Level 2	308,081	308,932	279,378	278,705
Accrued interest receivable	Level 2	3,554	3,554	2,590	2,590
		<u>\$ 802,911</u>	<u>\$ 803,762</u>	<u>\$ 725,502</u>	<u>\$ 724,829</u>
Liabilities and Stockholders' Equity:					
Deposits, noninterest-bearing	Level 2	\$ 141,788	\$ 141,788	\$ 131,593	\$ 131,593
Deposits, interest-bearing	Level 2	581,441	583,626	518,011	520,795
Short-term borrowings	Level 2	19,967	19,967	11,700	11,700
Accrued interest payable	Level 2	771	771	5,045	5,045
Accrued expenses	Level 2	6,307	6,307	10,144	10,144
Commitments to sell mortgage loans	Level 2	-	-	2,233	2,233
Mortgage banking short positions	Level 2	-	-	52	52
Guaranteed preferred beneficial interests in Company's subordinated debentures	Level 2	22,432	16,908	22,430	14,849
		<u>\$ 772,706</u>	<u>\$ 769,367</u>	<u>\$ 701,208</u>	<u>\$ 696,411</u>
Net Fair Value of Financial Instruments			<u>\$ 34,395</u>		<u>\$ 28,418</u>
Financial instruments with off-balance-sheet risk:					
Commitments to extend credit	Level 2	\$ -	\$ 254	\$ -	\$ 94
Standby and commercial letters of credit	Level 2	\$ -	\$ 14	\$ -	\$ 14

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.

NOTE 18. 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, 2013, 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 16 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, 2013, 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):

	2013		2012	
	Fixed Rate	Variable Rate	Fixed Rate	Variable Rate
Commitments to extend credit	\$ 18,723	\$ 57,815	\$ 17,738	\$ 37,378
Standby and commercial letters of credit	597	841	523	937

In addition to the amounts in the table above, our mortgage banking commitments to fund loans totaled \$57.8 million at December 31, 2013 and \$161.0 million at December 31, 2012. Also, our mortgage banking commitments to sell loans totaled \$90.0 million at December 31, 2013 and \$253.2 million at December 31, 2012.

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>2013</u>	<u>2012</u>
Balance, beginning of period	\$ 1,500	\$ 800
Provision	745	849
Write offs	<u>(566)</u>	<u>(149)</u>
Balance, end of period	<u>\$ 1,679</u>	<u>\$ 1,500</u>

NOTE 19. 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, 2013 and 2012, the Bank had outstanding \$789 thousand and \$942 thousand, respectively, of performance standby letters of credit and \$4.9 million and \$4.7 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 in an event of 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 20. 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 \$3.1 million and \$2.6 million at December 31, 2013 and 2012, respectively. Originations in 2013 and 2012 totaled \$1.0 million and \$1.5 million, respectively. Loan paydowns in 2013 and 2012 were \$570,000 and \$162,000, respectively. The total amount of deposits received from these parties was \$2.2 million and \$2.3 million at December 31, 2013 and 2012, 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, 2013, BNCCORP and its affiliates were in compliance with these requirements.

NOTE 21. Income Taxes

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

	<u>2013</u>	<u>2012</u>
Current:		
Federal	\$ 1,719	\$ 343
State	166	7
	<u>1,885</u>	<u>350</u>
Deferred:		
Federal	1,356	6,106
State	574	1,523
Valuation allowance	7	(13,259)
	<u>1,937</u>	<u>(5,630)</u>
Total	<u>\$ 3,822</u>	<u>\$ (5,280)</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>2013</u>	<u>2012</u>
Tax expense (benefit) at 34% statutory rate	\$ 4,233	\$ 7,257
State taxes (net of Federal benefit)	610	1,198
Tax-exempt interest	(470)	(287)
Life insurance proceeds	(359)	-
Cash surrender values of bank-owned life insurance	(170)	(178)
Other, net	(29)	(11)
	<u>3,815</u>	<u>7,979</u>
Deferred tax valuation allowance	7	(13,259)
	<u>\$ 3,822</u>	<u>\$ (5,280)</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>2013</u>	<u>2012</u>
Deferred tax asset:		
Loans, primarily due to credit losses	\$ 4,451	\$ 4,639
Unrealized loss on securities available for sale	1,374	-
Acquired intangibles	211	216
Net operating loss carryforwards	414	1,387
Alternative minimum tax credits	959	900
Other real estate owned	665	1,694
Other	<u>376</u>	<u>463</u>
Deferred tax asset	<u>8,450</u>	<u>9,299</u>
Deferred tax liability:		
Unrealized gain on securities available for sale	-	2,468
Discount accretion on securities	656	983
Premises and equipment	732	759
Other	<u>340</u>	<u>291</u>
Deferred tax liability	<u>1,728</u>	<u>4,501</u>
	6,722	4,798
Valuation allowance	<u>(14)</u>	<u>(7)</u>
Net deferred tax asset	<u>\$ 6,708</u>	<u>\$ 4,791</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 state tax net operating losses aggregating \$6.7 million as of December 31, 2013. 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, 2010 through 2013 remain open to federal examination. Tax years ended December 31, 2009 through 2013 remain open to state examinations.

NOTE 22. Earnings Per Share

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

	<u>2013</u>	<u>2012</u>
Net income per share was calculated as follows:		
Denominator for basic earnings per share:		
Average common shares outstanding	3,297,235	3,291,660
Dilutive common stock options	<u>171,155</u>	<u>52,620</u>
Denominator for diluted earnings per share	<u><u>3,468,390</u></u>	<u><u>3,344,280</u></u>
Numerator (in thousands):		
Net income	\$ 8,627	\$ 26,624
Preferred stock costs	<u>(1,320)</u>	<u>(1,462)</u>
Net income available to common shareholders	<u><u>\$ 7,307</u></u>	<u><u>\$ 25,162</u></u>
Basic earnings per common share	<u><u>\$ 2.22</u></u>	<u><u>\$ 7.64</u></u>
Diluted earnings per common share	<u><u>\$ 2.11</u></u>	<u><u>\$ 7.52</u></u>

NOTE 23. Benefit Plans

BNCCORP has a qualified 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 2013 and 2012, 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 \$476,000 and \$464,000 for 2013 and 2012, 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, 2013, the assets in the plan totaled \$17.4 million and included \$503,000 (41,000 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 24. 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, 2013 and 2012 was \$1.2 million and \$908,000, respectively, for facilities, and \$21,000 and \$37,000, respectively, for equipment and other items. At December 31, 2013, the total minimum annual base lease payments for operating leases were as follows (in thousands):

2014	\$	790
2015		585
2016		579
2017		421
2018		156
Thereafter		1,370

NOTE 25. 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 and total shares available as of December 31, 2013 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	48,751	-	15,850	250,000	314,601

The Company recognized share-based compensation expense of \$46,000 and \$31,000 for the years ended December 31, 2013 and 2012, respectively, related to restricted stock.

The tax benefits associated with share-based compensation was approximately \$17,000 for the year ended December 31, 2013 and would have been \$14,000 for the year ended December 31, 2012, if the Company had not been in a full valuation allowance.

At December 31, 2013, the Company had \$254,000 of unamortized restricted stock compensation. At December 31, 2012, the Company had \$3,000 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:

	2013		2012	
	Number Restricted Stock Shares	Weighted Average Grant Date Fair Value	Number Restricted Stock Shares	Weighted Average Grant Date Fair Value
Nonvested, beginning of year	3,300	\$ 1.50	9,100	\$ 4.47
Granted	25,000	11.88	-	-
Vested	(3,300)	1.50	(5,800)	6.16
Forfeited	-	-	-	-
Nonvested, end of year	<u>25,000</u>	11.88	<u>3,300</u>	1.50

The Company granted 240,000 stock options on March 17, 2010. The stock options had 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 \$0 and \$29,000 for the years ended December 31, 2013 and 2012, respectively, related to share options. At December 31, 2013, the Company had \$0 of unamortized compensation cost related to non-vested stock options.

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, 2013:

	Stock Options Outstanding	Stock Options Currently Exercisable	Stock Options Vested and Expected to Vest
Number	163,200	163,200	163,200
Weighted-average exercise price	\$3.00	\$3.00	\$3.00
Weighted-average remaining contractual term	6.21 years	6.21 years	6.21 years

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

	2013		2012	
	Options to Purchase Shares	Weighted Average Exercise Price	Options to Purchase Shares	Weighted Average Exercise Price
Outstanding, beginning of year	228,000	\$ 3.00	236,500	\$ 3.14
Granted	-	\$ -	-	\$ -
Exercised	(64,800)	\$ 3.00	(8,500)	\$ 7.00
Forfeited	-	\$ -	-	\$ -
Outstanding, end of year	<u>163,200</u>	\$ 3.00	<u>228,000</u>	\$ 3.00
Exercisable, end of year	<u>163,200</u>	\$ 3.00	<u>228,000</u>	\$ 3.00
Weighted average fair value of				
Granted	\$ -		\$ -	
Exercised	\$ 1.47		\$ 3.76	
Forfeited	\$ -		\$ -	

Following is a summary of the status of options outstanding at December 31, 2013:

	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	163,200	6.21 years	\$ 3.00	163,200	\$ 3.00

NOTE 26. 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)

	2013	2012
Assets:		
Cash and cash equivalents	\$ 9,068	\$ 12,630
Investment in subsidiaries	83,675	78,961
Receivable from subsidiaries	381	1,179
Other	1,739	2,337
Total assets	\$ 94,863	\$ 95,107
Liabilities and stockholders' equity:		
Subordinated debentures	\$ 22,432	\$ 22,430
Payable to subsidiaries	56	54
Accrued expenses and other liabilities	1,493	9,305
Total liabilities	23,981	31,789
Preferred stock, \$.01 par value. Authorized 2,000,000 shares:		
Preferred Stock - 5% Series A 20,093 shares issued and outstanding;	20,093	19,859
Preferred Stock - 9% Series B 1,005 shares issued and outstanding;	1,005	1,029
Common stock, \$.01 par value – Authorized 35,000,000 shares 3,374,601 and 3,300,652 shares issued and outstanding	34	33
Capital surplus – common stock	26,133	27,257
Retained earnings	27,962	20,655
Treasury stock (294,052 and 368,001 shares, respectively)	(3,894)	(5,064)
Accumulated other comprehensive loss, net of income taxes	(451)	(451)
Total stockholders' equity	70,882	63,318
Total liabilities and stockholders' equity	\$ 94,863	\$ 95,107

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

	2013	2012
Income:		
Management fee income	\$ 1,835	\$ 1,652
Interest	11	8
Other	38	38
Total income	1,884	1,698
Expenses:		
Interest	1,197	1,631
Salaries and benefits	836	856
Legal and other professional	799	618
Depreciation and amortization	1	1
Other	824	887
Total expenses	3,657	3,993
Loss before income tax benefit and equity in income (loss) of subsidiaries	(1,773)	(2,295)
Income tax benefit	684	3,089
Income (loss) before equity in income of subsidiaries	(1,089)	794
Equity in earnings of subsidiaries	9,716	25,830
Net income	\$ 8,627	\$ 26,624

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

	<u>2013</u>	<u>2012</u>
Operating activities:		
Net income	\$ 8,627	\$ 26,624
Adjustments to reconcile net income to net cash provided by (used in) operating activities -		
Equity in undistributed income of subsidiaries	(9,716)	(25,830)
Depreciation and amortization	1	3
Share based compensation	(1,123)	40
Change in prepaid expenses and other receivables	2,566	(3,109)
Change in accrued expenses and other liabilities	<u>(4,237)</u>	<u>1,660</u>
Net cash used in operating activities	<u>(3,882)</u>	<u>(612)</u>
Investing activities:		
Dividend paid by subsidiaries	<u>5,000</u>	<u>10,000</u>
Net cash provided by investing activities	<u>5,000</u>	<u>10,000</u>
Financing activities:		
Payment of preferred stock dividends	<u>(4,680)</u>	<u>-</u>
Net cash used in financing activities	<u>(4,680)</u>	<u>-</u>
Net increase (decrease) in cash and cash equivalents	(3,562)	9,388
Cash and cash equivalents, beginning of year	<u>12,630</u>	<u>3,242</u>
Cash and cash equivalents, end of year	<u>\$ 9,068</u>	<u>\$ 12,630</u>
Supplemental cash flow information:		
Interest paid	<u>\$ 3,112</u>	<u>\$ 3,259</u>
Income taxes paid	<u>\$ 1,720</u>	<u>\$ 699</u>

NOTE 27. Subsequent Events

The Company has evaluated subsequent events from the balance sheet date through March 18, 2014, 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

Timothy J. Franz
President/CEO
602-852-3526

Daniel Collins
Chief Financial Officer
612-305-2210

General Inquiries:

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

Annual Meeting

The 2014 annual meeting of stockholders will be held on Wednesday, June 18, 2014 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 OTCQB Markets under the symbol: "BNCC."

COMMON STOCK PRICES

For the Years Ended December 31,

	2013(1)		2012(1)	
	High	Low	High	Low
First Quarter	\$12.89	\$10.05	\$6.77	\$2.02
Second Quarter	\$12.10	\$10.40	\$2.50	\$2.00
Third Quarter	\$14.40	\$11.70	\$6.50	\$2.11
Fourth Quarter	\$14.00	\$12.11	\$10.55	\$6.10

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

Tracy Scott
Chairman of the Board and Retired Co-Founder of BNCCORP, INC.

Timothy J. Franz
President and Chief Executive Officer of BNCCORP, INC.

Gaylen Ghylin,
EVP, Secretary and CFO of 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 of Johnsen Trailer Sales, Inc.

Michael O'Rourke
Attorney / Author

Directors, BNC National Bank

Doug Brendel
Shawn Cleveland
Timothy J. Franz
Dave Hoekstra
Mark E. Peiler
Scott Spillman
Cheryl A. Stanton

SUBSIDIARIES

BNC 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

Golden Valley
650 North Douglas Drive
Golden Valley, MN 55422

Perimeter
17550 North Perimeter Drive
Scottsdale, AZ 85255

Mortgage Banking Branches:

Glendale
6685 W. Beardsley Road
Glendale, AZ 85383

Scottsdale
17550 North Perimeter Dr., Ste 140
Scottsdale, AZ 85255

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
20101 E. Jackson Drive
Independence, MO 64055

Lincoln
6120 Apples Way
Lincoln, NE 68516

Omaha
12103 Anne Street
Omaha, NE 68137

BNC also provides mortgage banking services within the following bank branches:

Bismarck Main
322 East Main Avenue
Bismarck, ND 58501

Bismarck North
801 East Century Avenue
Bismarck, ND 58503

Golden Valley
650 North Douglas Drive
Golden Valley, MN 55422



BNCCORP, INC.

322 East Main Avenue
Bismarck, ND 58501
(701) 250-3040
www.bnccorp.com

OTCQB

