



BNCCORP, INC.

Quarterly Report

For the quarter ended September 30, 2014

BNCCORP, INC.

(OTCQX: BNCC)

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BNCCORP, INC.
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September 30, 2014

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FINANCIAL INFORMATION

Item 1. Financial Statements

BNCCORP, INC. AND SUBSIDIARIES

Consolidated Balance Sheets
(In thousands, except share data)

ASSETS	September 30, 2014 (unaudited)	December 31, 2013
CASH AND CASH EQUIVALENTS	\$ 28,781	\$ 18,871
INVESTMENT SECURITIES AVAILABLE FOR SALE	456,192	435,719
FEDERAL RESERVE BANK AND FEDERAL HOME LOAN BANK STOCK	2,817	2,729
LOANS HELD FOR SALE-MORTGAGE BANKING	42,441	32,870
LOANS AND LEASES HELD FOR INVESTMENT	335,364	317,928
ALLOWANCE FOR CREDIT LOSSES	(8,675)	(9,847)
Net loans and leases held for investment	326,689	308,081
OTHER REAL ESTATE, net	1,056	1,056
PREMISES AND EQUIPMENT, net	15,819	14,870
ACCRUED INTEREST RECEIVABLE	3,248	3,554
OTHER	22,677	25,373
Total assets	<u>\$ 899,720</u>	<u>\$ 843,123</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
DEPOSITS:		
Non-interest-bearing	\$ 156,704	\$ 141,788
Interest-bearing –		
Savings, interest checking and money market	427,504	378,355
Time deposits under \$100,000	110,578	123,058
Time deposits \$100,000 and over	79,480	80,028
Total deposits	774,266	723,229
SHORT-TERM BORROWINGS	20,714	19,967
LONG-TERM BORROWINGS	2,300	-
GUARANTEED PREFERRED BENEFICIAL INTERESTS IN COMPANY'S SUBORDINATED DEBENTURES	15,018	22,432
ACCRUED INTEREST PAYABLE	368	771
ACCRUED EXPENSES	6,565	6,307
OTHER	733	552
Total liabilities	819,964	773,258
STOCKHOLDERS' EQUITY:		
Preferred stock, \$.01 par value – Authorized 2,000,000 shares:		
Preferred stock - 9% Series A 20,093 shares outstanding;	20,093	20,093
Preferred stock - 9% Series B 1,005 shares outstanding;	1,005	1,005
Common stock, \$.01 par value – Authorized 35,000,000 shares; 3,413,854 and 3,374,601 shares issued and outstanding	34	34
Capital surplus – common stock	25,800	26,133
Retained earnings	32,620	27,962
Treasury stock (254,799 and 294,052 shares, respectively)	(3,421)	(3,894)
Accumulated other comprehensive income (loss), net	3,625	(1,468)
Total stockholders' equity	<u>79,756</u>	<u>69,865</u>
Total liabilities and stockholders' equity	<u>\$ 899,720</u>	<u>\$ 843,123</u>

See accompanying notes to consolidated financial statements

BNCCORP, INC. AND SUBSIDIARIES

Consolidated Statements of Income

(In thousands, except per share data, unaudited)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2014	2013	2014	2013
INTEREST INCOME:				
Interest and fees on loans	\$ 4,492	\$ 3,811	\$ 12,852	\$ 11,726
Interest and dividends on investments				
Taxable	2,461	1,351	7,320	4,012
Tax-exempt	559	370	1,658	947
Dividends	28	28	85	84
Total interest income	<u>7,540</u>	<u>5,560</u>	<u>21,915</u>	<u>16,769</u>
INTEREST EXPENSE:				
Deposits	584	645	1,837	2,038
Short-term borrowings	10	10	28	30
Long-term borrowings	14	-	14	-
Subordinated debentures	183	289	759	869
Total interest expense	<u>791</u>	<u>944</u>	<u>2,638</u>	<u>2,937</u>
Net interest income	6,749	4,616	19,277	13,832
PROVISION (REDUCTION) FOR CREDIT LOSSES	<u>(200)</u>	<u>-</u>	<u>(800)</u>	<u>700</u>
NET INTEREST INCOME AFTER PROVISION (REDUCTION) FOR CREDIT LOSSES	<u>6,949</u>	<u>4,616</u>	<u>20,077</u>	<u>13,132</u>
NON-INTEREST INCOME:				
Bank charges and service fees	743	698	2,114	1,989
Wealth management revenues	331	302	1,066	935
Mortgage banking revenues, net	2,782	2,422	8,455	17,413
Gains on sales of loans, net	688	301	1,688	1,408
Gains on sales of securities, net	-	37	528	1,247
Life insurance benefits received	-	1,055	-	1,055
Other	270	186	608	630
Total non-interest income	<u>4,814</u>	<u>5,001</u>	<u>14,459</u>	<u>24,677</u>
NON-INTEREST EXPENSE:				
Salaries and employee benefits	4,435	3,637	13,217	12,991
Professional services	848	861	2,237	2,883
Data processing fees	745	717	2,183	2,218
Marketing and promotion	813	718	2,121	1,927
Occupancy	588	597	1,561	1,765
Regulatory costs	158	146	466	680
Depreciation and amortization	315	311	922	928
Office supplies and postage	156	139	495	461
Other real estate costs	27	38	59	164
Impairment charge	-	1,500	-	1,500
Other	680	787	2,481	2,390
Total non-interest expense	<u>8,765</u>	<u>9,451</u>	<u>25,742</u>	<u>27,907</u>
Income before income taxes	2,998	166	8,794	9,902
Income tax expense (benefit)	1,017	(321)	2,814	3,154
Net income	1,981	487	5,980	6,748
Preferred stock costs	475	330	1,322	981
Net income available to common shareholders	<u>\$ 1,506</u>	<u>\$ 157</u>	<u>\$ 4,658</u>	<u>\$ 5,767</u>
Basic earnings per common share	<u>\$ 0.44</u>	<u>\$ 0.05</u>	<u>\$ 1.38</u>	<u>\$ 1.75</u>
Diluted earnings per common share	<u>\$ 0.43</u>	<u>\$ 0.05</u>	<u>\$ 1.34</u>	<u>\$ 1.66</u>

See accompanying notes to consolidated financial statements.

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

	For the Three Months				For the Nine Months			
	Ended September 30,		Ended September 30,		Ended September 30,		Ended September 30,	
	2014	2013	2014	2013	2014	2013	2014	2013
NET INCOME	\$ 1,981	\$ 487	\$ 5,980	\$ 6,748				
Unrealized gain (loss) on securities available for sale	\$ 508	\$ 2,422	\$ 8,645	\$ (6,170)				
Reclassification adjustment for (gain) loss included in net income	-	(37)	(528)	(1,247)				
Other comprehensive income (loss) before tax	508	2,385	8,117	(7,417)				
Income tax benefit (expense) related to items of other comprehensive income (loss)	(193)	(906)	(3,024)	2,819				
Other comprehensive income (loss)	315	1,479	5,093	(4,598)	315	1,479	5,093	(4,598)
TOTAL COMPREHENSIVE INCOME (LOSS)	<u>\$ 2,296</u>	<u>\$ 1,966</u>	<u>\$ 11,073</u>	<u>\$ 2,150</u>				

See accompanying notes to consolidated financial statements.

BNCCORP, INC. AND SUBSIDIARIES
Consolidated Statements of Stockholders' Equity
For the Nine Months Ended September 30,
(In thousands, except share data, unaudited)

	Preferred Stock		Common Stock		Capital	Retained	Treasury	Accumulated	Total
	Shares	Amount	Shares	Amount	Surplus	Earnings	Stock	Other	
					Common	(Deficit)		Comprehensive	
BALANCE, December 31, 2012	21,098	\$ 20,888	3,300,652	\$ 33	\$ 27,257	\$ 20,655	\$ (5,064)	\$ 4,961	\$ 68,730
Net income	-	-	-	-	-	6,748	-	-	6,748
Other comprehensive loss	-	-	-	-	-	-	-	(4,598)	(4,598)
Preferred stock amortization, net	-	151	-	-	-	(151)	-	-	-
Dividend on preferred stock	-	-	-	-	-	(831)	-	-	(831)
Impact of share-based compensation	-	-	23,932	-	(166)	-	188	-	22
BALANCE, September 30, 2013	21,098	\$ 21,039	3,324,584	\$ 33	\$ 27,091	\$ 26,421	\$ (4,876)	\$ 363	\$ 70,071
BALANCE, December 31, 2013	21,098	\$ 21,098	3,374,601	\$ 34	\$ 26,133	\$ 27,962	\$ (3,894)	\$ (1,468)	\$ 69,865
Net income	-	-	-	-	-	5,980	-	-	5,980
Other comprehensive income	-	-	-	-	-	-	-	5,093	5,093
Preferred stock amortization, net	-	-	-	-	-	-	-	-	-
Dividend on preferred stock	-	-	-	-	-	(1,322)	-	-	(1,322)
Impact of share-based compensation	-	-	39,253	-	(333)	-	473	-	140
BALANCE, September 30, 2014	21,098	\$ 21,098	3,413,854	\$ 34	\$ 25,800	\$ 32,620	\$ (3,421)	\$ 3,625	\$ 79,756

See accompanying notes to consolidated financial statements.

BNCCORP, INC. AND SUBSIDIARIESConsolidated Statements of Cash Flows
For the Nine Months Ended September 30,
(In thousands, unaudited)

	<u>2014</u>	<u>2013</u>
OPERATING ACTIVITIES:		
Net income	\$ 5,980	\$ 6,748
Adjustments to reconcile net income to net cash provided by operating activities -		
Provision (reduction) for credit losses	(800)	700
Provision for other real estate losses	-	40
Depreciation and amortization	922	928
Net amortization of premiums and (discounts) on investment securities and subordinated debentures	4,205	6,298
Share-based compensation	140	22
Impairment charge	-	1,500
Change in interest receivable and other assets, net	2,128	(1,860)
(Gain) loss on sale of other real estate	(52)	-
(Gain) loss on sale of bank premises and equipment	(9)	11
Net realized gain on sales of investment securities	(528)	(1,247)
Provision for deferred income taxes	2,395	(1,049)
Change in other liabilities, net	(2,320)	(4,060)
Funding of originations of loans held for sale	(459,415)	(807,258)
Proceeds from sales of loans held for sale	450,189	865,932
Fair value adjustment for loans held for sale	(344)	2,077
Unrealized (gain) loss on mortgage banking derivatives	(561)	3,481
Proceeds from sales of loans	15,173	13,793
Gains on sales of loans, net	(1,688)	(1,408)
Net cash provided by (used in) operating activities	<u>15,415</u>	<u>84,648</u>
INVESTING ACTIVITIES:		
Purchases of investment securities	(92,890)	(217,741)
Proceeds from sales of investment securities	34,033	58,109
Proceeds from maturities of investment securities	41,181	44,875
Purchases of Federal Reserve and Federal Home Loan Bank Stock	(1,284)	(129)
Sales of Federal Reserve and Federal Home Loan Bank Stock	1,196	1
Net (increase) decrease in loans held for investment	(31,991)	(18,686)
Proceeds from sales of other real estate	750	3,705
Proceeds from sales of bank premises and equipment	786	-
Additions to bank premises and equipment	(2,647)	(1,650)
Net cash provided by (used in) investing activities	<u>(50,866)</u>	<u>(131,516)</u>

See accompanying notes to consolidated financial statements.

BNCCORP, INC. AND SUBSIDIARIES
Consolidated Statements of Cash Flows, continued
For the Nine Months Ended September 30,
(In thousands, unaudited)

	2014	2013
FINANCING ACTIVITIES:		
Net increase (decrease) in deposits	\$ 51,037	\$ 56,891
Net increase (decrease) in short-term borrowings	747	10,321
Increase in long-term borrowings	2,300	-
Decrease in long-term borrowings	(7,500)	-
Repayments of Federal Home Loan Bank advances	(29,800)	(20)
Proceeds from Federal Home Loan Bank advances	29,800	20
Dividends paid on preferred stock	(1,223)	(4,406)
Net cash provided by (used in) financing activities	45,361	62,806
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	9,910	15,938
CASH AND CASH EQUIVALENTS, beginning of period	18,871	40,790
CASH AND CASH EQUIVALENTS, end of period	\$ 28,781	\$ 56,728
SUPPLEMENTAL CASH FLOW INFORMATION:		
Interest paid	\$ 3,041	\$ 7,385
Income taxes paid	\$ 1,984	\$ 1,360
SUPPLEMENTAL DISCLOSURE OF NONCASH INVESTING AND FINANCING ACTIVITIES:		
Additions to other real estate in settlement of loans and transfers of premises and equipment	\$ 697	\$ 800

See accompanying notes to consolidated financial statements.

BNCCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
September 30, 2014

NOTE 1 – Organization of Operations, BNCCORP, INC.

BNCCORP, INC. (BNCCORP) is a registered bank holding company incorporated under the laws of Delaware. It is the parent company of BNC National Bank (together with its wholly owned 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 12 locations in Arizona, Minnesota, North Dakota, Illinois and Kansas.

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

NOTE 2 – Basis of Presentation and Accounting Policies

The accompanying interim consolidated financial statements have been prepared under the presumption that users of the interim consolidated financial information have either read or have access to the audited consolidated financial statements of BNCCORP, INC. and subsidiaries for the year ended December 31, 2013. Accordingly, footnote disclosures which would substantially duplicate the disclosures contained in the December 31, 2013 audited consolidated financial statements have been omitted from these interim consolidated financial statements. These interim consolidated financial statements should be read in conjunction with the audited consolidated financial statements for the year ended December 31, 2013 and the notes thereto.

The accompanying interim consolidated financial statements have been prepared by the Company, in accordance with accounting principles generally accepted in the United States of America for interim financial information. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the reporting period. These estimates are based on information available to management at the time the estimates are made.

The unaudited consolidated financial statements as of September 30, 2014 include, in the opinion of management, all adjustments, consisting solely of normal recurring adjustments, necessary for a fair presentation of the financial results for the respective interim periods and are not necessarily indicative of results of operations to be expected for the entire fiscal year.

The Company's critical accounting policies are unchanged since December 31, 2013.

RECENTLY ISSUED OR ADOPTED ACCOUNTING PRONOUNCEMENTS

ASU 2014-14, *Receivables - Troubled Debt Restructuring by Creditors (Subtopic 310-40)* – Classification of Certain Government-Guaranteed Mortgage Loans upon Foreclosure, which will require creditors to derecognize certain foreclosed government-guaranteed mortgage loans and to recognize a separate other receivable that is measured at the amount the creditor expects to recover from the guarantor, and to treat the guarantee and the receivable as a single unit of account. ASU 2014-14 is effective for entities other than public business entities, for annual periods ending after December 15, 2015, and interim periods beginning after December 15, 2015. An entity can elect a prospective or a modified retrospective transition method, but must use the same transition method that it elected under FASB ASU No. 2014-04, *Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure*. Early adoption, including adoption in an interim period, is permitted if the entity already adopted ASU 2014-04. The Company does not expect the application of this guidance to have a material impact on the Company's consolidated financial statements.

ASU No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The ASU will replace most existing revenue recognition guidance in GAAP when it becomes effective. The new standard is effective for the Company for annual periods beginning after December 15, 2017 and interim periods within annual periods beginning after December 15, 2017. The standard permits the use of either the retrospective or cumulative effect transition method. The Company is evaluating the effect that ASU 2014-09 will have on its consolidated financial statements and related disclosures.

ASU No. 2014-04, *Receivables – Troubled Debt Restructuring by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans Upon Foreclosure*, was issued to clarify that when an in substance repossession or foreclosure occurs, a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. ASU 2014-04 is effective for annual reporting periods beginning after December 15, 2014. The Company does not expect the application of this guidance to have a material impact on the Company's consolidated financial statements.

FASB ASU 2011-02, *Receivables (Topic 310), A Creditor's Determination of Whether a Restructuring is a Troubled Debt Restructuring*, clarifies when the restructuring of a receivable should be considered a troubled debt restructuring (TDR). FASB issued the guidance in response to constituents' concerns that creditors were inconsistently applying the guidance for 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 6 in the Company's notes to the consolidated financial statements.

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 did not 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 an 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 2015 is not expected 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.

NOTE 3 – Capital and Current Operating Environment

Capital amounts and ratios of BNCCORP and the Bank 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
September 30, 2014								
Total Risk Based Capital:								
Consolidated	\$ 96,822	21.48 %	\$ 36,063	≥8.0 %	\$ N/A	N/A %	\$ N/A	N/A %
BNC National Bank	96,586	21.60	35,777	≥8.0	44,721	10.0	51,865	11.60
Tier 1 Risk Based Capital :								
Consolidated	91,150	20.22	18,031	≥4.0	N/A	N/A	N/A	N/A
BNC National Bank	90,958	20.34	17,888	≥4.0	26,832	6.0	64,126	14.34
Tier 1 Leverage Capital:								
Consolidated	91,150	10.13	35,987	≥4.0	N/A	N/A	N/A	N/A
BNC National Bank	90,958	10.12	35,962	≥4.0	44,952	5.0	46,006	5.12
Tangible Equity (to total assets):								
Consolidated tangible equity	79,673	8.86	N/A	N/A	N/A	N/A	N/A	N/A
BNC National Bank	94,951	10.56	N/A	N/A	N/A	N/A	N/A	N/A
Tangible Common Equity (to total assets):								
Consolidated tangible common equity	58,575	6.51	N/A	N/A	N/A	N/A	N/A	N/A
BNC National Bank	94,951	10.56	N/A	N/A	N/A	N/A	N/A	N/A
December 31, 2013								
Total Risk Based Capital:								
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 Risk Based Capital :								
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 Leverage Capital:								
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
BNC National Bank	82,592	9.82	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 regulatory amounts required to be considered well capitalized. We are managing capital accordingly. 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.

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.

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. We have reviewed estimates of our regulatory capital ratios under the new Basel III framework and expect to be in compliance with these standards.

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 September 30, 2014 or December 31, 2013. The carrying amount of available-for-sale securities and their approximate fair values were as follows (in thousands):

	As of September 30, 2014			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. Treasury securities	\$ 11,897	\$ -	\$ (11)	\$ 11,886
U.S. government agency mortgage-backed securities guaranteed by GNMA	67,816	589	(817)	67,588
U.S. government agency mortgage-backed securities issued by FNMA or FHLMC	15,051	-	(225)	14,826
U.S. government agency small business administration pools guaranteed by SBA	75,152	211	(196)	75,167
Collateralized mortgage obligations guaranteed by GNMA/VA	126,984	1,204	(883)	127,305
Collateralized mortgage obligations issued by FNMA or FHLMC	89,696	808	(819)	89,685
Other collateralized mortgage obligations	-	-	-	-
State and municipal bonds	65,271	4,484	(20)	69,735
	<u>\$ 451,867</u>	<u>\$ 7,296</u>	<u>\$ (2,971)</u>	<u>\$ 456,192</u>
	As of December 31, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. Treasury securities	\$ -	\$ -	\$ -	\$ -
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>

The amortized cost and estimated fair market value of available-for-sale securities classified according to their contractual maturities at September 30, 2014 were as follows (in thousands):

	Amortized Cost	Estimated Fair Value
Due in one year or less	\$ -	\$ -
Due after one year through five years	11,897	11,886
Due after five years through ten years	27,574	27,470
Due after ten years	412,396	416,836
Total	<u>\$ 451,867</u>	<u>\$ 456,192</u>

Actual maturities may differ from the contractual maturities shown above as a result of prepayments.

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 (dollars are in thousands):

September 30, 2014

Description of Securities	Less than 12 months			12 months or more			Total		
	#	Fair Value	Unrealized Loss	#	Fair Value	Unrealized Loss	#	Fair Value	Unrealized Loss
	U.S. Treasury securities	1	\$ 11,886	\$ (11)	-	\$ -	\$ -	1	\$ 11,886
U.S. government agency mortgage-backed securities guaranteed by GNMA	2	12,061	(105)	2	17,556	(712)	4	29,617	(817)
U.S. government agency mortgage-backed securities issued by FNMA or FHLMC	-	-	-	4	14,826	(225)	4	14,826	(225)
U.S. government agency small business administration pools guaranteed by SBA	8	35,521	(140)	3	6,360	(56)	11	41,881	(196)
Collateralized mortgage obligations guaranteed by GNMA/VA	5	16,219	(154)	7	25,517	(729)	12	41,736	(883)
Collateralized mortgage obligations issued by FNMA or FHLMC	4	23,264	(314)	4	15,668	(505)	8	38,932	(819)
Other collateralized mortgage obligations	-	-	-	-	-	-	-	-	-
State and municipal bonds	1	3,260	(2)	1	2,329	(18)	2	5,589	(20)
Total temporarily impaired securities	21	\$ 102,211	\$ (726)	21	\$ 82,256	\$ (2,245)	42	\$ 184,467	\$ (2,971)

December 31, 2013

Description of Securities	Less than 12 months			12 months or more			Total		
	#	Fair Value	Unrealized Loss	#	Fair Value	Unrealized Loss	#	Fair Value	Unrealized Loss
	U.S. Treasury securities	-	\$ -	\$ -	-	\$ -	\$ -	-	\$ -
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)

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 management concluded were other-than-temporarily impaired at September 30, 2014 or December 31, 2013.

NOTE 5 – Loans and Leases

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

	<u>September 30, 2014</u>	<u>December 31, 2013</u>
Loans held for sale-mortgage banking	\$ 42,441	\$ 32,870
Commercial and industrial	\$ 120,083	\$ 132,983
Commercial real estate	101,852	93,330
SBA	25,593	18,215
Consumer	35,779	32,612
Land and land development	26,235	27,582
Construction	<u>25,929</u>	<u>13,286</u>
	335,471	318,008
Unearned income and net unamortized deferred fees and costs	<u>(107)</u>	<u>(80)</u>
Loans, net of unearned income and unamortized fees and costs	335,364	317,928
Allowance for credit losses	<u>(8,675)</u>	<u>(9,847)</u>
Net loans and leases held for investment	<u>\$ 326,689</u>	<u>\$ 308,081</u>

NOTE 6 – Allowance for Credit Losses

Transactions in the allowance for credit losses were as follows (in thousands):

Three Months Ended September 30, 2014

	Commercial and industrial	Commercial real estate	SBA	Consumer	Land and land development	Construction	Total
Balance, beginning of period	\$ 2,326	\$ 2,707	\$ 874	\$ 493	\$ 2,196	\$ 232	\$ 8,828
Provision (reduction)	634	(813)	449	33	(593)	90	(200)
Loans charged off	-	-	(7)	(4)	-	-	(11)
Loan recoveries	-	-	5	3	50	-	58
Balance, end of period	<u>\$ 2,960</u>	<u>\$ 1,894</u>	<u>\$ 1,321</u>	<u>\$ 525</u>	<u>\$ 1,653</u>	<u>\$ 322</u>	<u>\$ 8,675</u>

Three Months Ended September 30, 2013

	Commercial and industrial	Commercial real estate	SBA	Consumer	Land and land development	Construction	Total
Balance, beginning of period	\$ 2,156	\$ 4,413	\$ 734	\$ 469	\$ 2,025	\$ 101	\$ 9,898
Provision (reduction)	40	(358)	89	39	187	3	-
Loans charged off	-	-	-	(16)	-	-	(16)
Loan recoveries	-	-	-	3	12	-	15
Balance, end of period	<u>\$ 2,196</u>	<u>\$ 4,055</u>	<u>\$ 823</u>	<u>\$ 495</u>	<u>\$ 2,224</u>	<u>\$ 104</u>	<u>\$ 9,897</u>

Nine Months Ended September 30, 2014

	<u>Commercial and industrial</u>	<u>Commercial real estate</u>	<u>SBA</u>	<u>Consumer</u>	<u>Land and land development</u>	<u>Construction</u>	<u>Total</u>
Balance, beginning of period	\$ 2,215	\$ 4,041	\$ 579	\$ 478	\$ 2,371	\$ 163	\$ 9,847
Provision (reduction)	745	(1,716)	787	53	(828)	159	(800)
Loans charged off	-	(439)	(50)	(26)	(190)	-	(705)
Loan recoveries	-	8	5	20	300	-	333
Balance, end of period	<u>\$ 2,960</u>	<u>\$ 1,894</u>	<u>\$ 1,321</u>	<u>\$ 525</u>	<u>\$ 1,653</u>	<u>\$ 322</u>	<u>\$ 8,675</u>

Nine Months Ended September 30, 2013

	<u>Commercial and industrial</u>	<u>Commercial real estate</u>	<u>SBA</u>	<u>Consumer</u>	<u>Land and land development</u>	<u>Construction</u>	<u>Total</u>
Balance, beginning of period	\$ 2,546	\$ 4,790	\$ 616	\$ 382	\$ 1,609	\$ 148	\$ 10,091
Provision (reduction)	566	(740)	207	166	545	(44)	700
Loans charged off	(916)	(3)	-	(64)	-	-	(983)
Loan recoveries	-	8	-	11	70	-	89
Balance, end of period	<u>\$ 2,196</u>	<u>\$ 4,055</u>	<u>\$ 823</u>	<u>\$ 495</u>	<u>\$ 2,224</u>	<u>\$ 104</u>	<u>\$ 9,897</u>

The following table shows the balance in the allowance for credit losses at September 30, 2014, and December 31, 2013, and the related loan balances, segregated on the basis of impairment methodology (in thousands). Loans evaluated under ASC 310-10-35 include loans on nonaccrual status and troubled debt restructurings, which are individually evaluated for impairment, and other impaired loans deemed to have similar risk characteristics. All other loans are collectively evaluated for impairment under ASC 450-20.

	<u>Allowance For Credit Losses</u>			<u>Gross Loans and Leases Held for Investment</u>		
	<u>Under ASC 310-10-35</u>	<u>Under ASC 450-20</u>	<u>Total</u>	<u>Evaluated for Impairment Under ASC 310-10-35</u>	<u>Evaluated for Impairment Under ASC 450-20</u>	<u>Total</u>
September 30, 2014						
Commercial and industrial	\$ 15	\$ 2,945	\$ 2,960	\$ 90	\$ 119,993	\$ 120,083
Commercial real estate	672	1,222	1,894	4,770	97,082	101,852
SBA	48	1,273	1,321	58	25,535	25,593
Consumer	8	517	525	331	35,448	35,779
Land and land development	-	1,653	1,653	-	26,235	26,235
Construction	-	322	322	-	25,929	25,929
Total	<u>\$ 743</u>	<u>\$ 7,932</u>	<u>\$ 8,675</u>	<u>\$ 5,249</u>	<u>\$ 330,222</u>	<u>\$ 335,471</u>
December 31, 2013						
Commercial and industrial	\$ 30	\$ 2,185	\$ 2,215	\$ 430	\$ 132,553	\$ 132,983
Commercial real estate	1,030	3,011	4,041	4,188	89,142	93,330
SBA	-	579	579	-	18,215	18,215
Consumer	-	478	478	38	32,574	32,612
Land and land development	-	2,371	2,371	-	27,582	27,582
Construction	-	163	163	-	13,286	13,286
Total	<u>\$ 1,060</u>	<u>\$ 8,787</u>	<u>\$ 9,847</u>	<u>\$ 4,656</u>	<u>\$ 313,352</u>	<u>\$ 318,008</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 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 (in thousands):

September 30, 2014						
	Current	31-89 Days Past Due	90 Days or More Past Due and Accruing	Total Performing	Non-accrual	Total
Commercial and industrial:						
Business loans	\$ 63,457	\$ 396	\$ -	\$ 63,853	\$ 37	\$ 63,948
Agriculture	18,611	-	-	18,611	-	18,611
Owner-occupied commercial real estate	37,524	-	-	37,524	-	37,524
Commercial real estate	101,852	-	-	101,852	-	101,852
SBA	25,593	-	-	25,593	58	25,593
Consumer:						
Automobile	6,412	-	17	6,429	17	6,446
Home equity	5,446	-	-	5,446	-	5,446
1st mortgage	9,872	-	-	9,872	-	9,872
Other	13,977	37	1	14,015	-	14,015
Land and land development	26,235	-	-	26,235	-	26,235
Construction	25,929	-	-	25,929	-	25,929
Total loans held for investment	<u>334,908</u>	<u>433</u>	<u>18</u>	<u>335,359</u>	<u>112</u>	<u>335,471</u>
Loans held for sale	<u>42,441</u>	<u>-</u>	<u>-</u>	<u>42,441</u>	<u>-</u>	<u>42,441</u>
Total gross loans	<u>\$ 377,349</u>	<u>\$ 433</u>	<u>\$ 18</u>	<u>\$ 377,800</u>	<u>\$ 112</u>	<u>\$ 377,912</u>

December 31, 2013

	<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	\$ 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 Construction	26,621 13,286	- -	961 -	27,582 13,286	- -	27,582 13,286
Total loans held for investment	<u>312,279</u>	<u>112</u>	<u>961</u>	<u>313,352</u>	<u>4,656</u>	<u>318,008</u>
Loans held for sale	<u>32,870</u>	<u>-</u>	<u>-</u>	<u>32,870</u>	<u>-</u>	<u>32,870</u>
Total gross loans	<u>\$ 345,149</u>	<u>\$ 112</u>	<u>\$ 961</u>	<u>\$ 346,222</u>	<u>\$ 4,656</u>	<u>\$ 350,878</u>

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

	<u>Three Months Ended September 30,</u>		<u>Nine Months Ended September 30,</u>	
	<u>2014</u>	<u>2013</u>	<u>2014</u>	<u>2013</u>
Interest income that would have been recorded	\$ 7	\$ 133	\$ 9	\$ 378
Interest income recorded	-	-	-	-
Effect on interest income	<u>\$ 7</u>	<u>\$ 133</u>	<u>\$ 9</u>	<u>\$ 378</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 loans and loans that have been modified in a troubled debt restructuring. All loans are individually reviewed for impairment.

The following tables summarize impaired loans and related allowances (in thousands):

September 30, 2014

	<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	\$ 90	\$ 90	\$ 15	\$ 100	\$ 2
Agriculture	-	-	-	-	-
Owner-occupied commercial real estate	-	-	-	-	-
Commercial real estate	8,655	4,770	672	5,377	76
SBA	65	58	48	58	-
Consumer:					
Automobile	-	-	-	-	-
Home equity	-	-	-	-	-
1st mortgage	1,878	313	8	466	10
Other	-	-	-	-	-
Land and land development	-	-	-	-	-
Construction	-	-	-	-	-
Loans held for sale	-	-	-	-	-
Total impaired loans with an allowance recorded	<u>\$ 10,688</u>	<u>\$ 5,231</u>	<u>\$ 743</u>	<u>\$ 6,001</u>	<u>\$ 88</u>
Impaired loans without an allowance recorded:					
Commercial and industrial:					
Business loans	\$ -	\$ -	\$ -	\$ -	\$ -
Agriculture	-	-	-	-	-
Owner-occupied commercial real estate	-	-	-	-	-
Commercial real estate	-	-	-	-	-
SBA	-	-	-	-	-
Consumer:					
Automobile	37	18	-	21	-
Home equity	-	-	-	-	-
1st mortgage	-	-	-	-	-
Other	-	-	-	-	-
Land and land development	-	-	-	-	-
Construction	-	-	-	-	-
Loans held for sale	-	-	-	-	-
Total impaired loans without an allowance recorded	<u>\$ 37</u>	<u>\$ 18</u>	<u>\$ -</u>	<u>\$ 21</u>	<u>\$ -</u>
TOTAL IMPAIRED LOANS	<u><u>\$ 10,725</u></u>	<u><u>\$ 5,249</u></u>	<u><u>\$ 743</u></u>	<u><u>\$ 6,022</u></u>	<u><u>\$ 88</u></u>

December 31, 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>

Troubled Debt Restructuring (TDRs)

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 tables below summarize the amounts of restructured loans (in thousands):

	September 30, 2014			
	Accrual	Non-accrual	Total	Allowance
Commercial and industrial:				
Business loans	\$ 53	\$ -	\$ 53	\$ 8
Agriculture	-	-	-	-
Owner-occupied commercial real estate	-	-	-	-
Commercial real estate	4,770	-	4,770	672
SBA	-	-	-	-
Consumer:				
Automobile	-	-	-	-
Home equity	-	-	-	-
1st mortgage	313	-	313	8
Other	-	-	-	-
Land and land development	-	-	-	-
Construction	-	-	-	-
Loans held for sale	-	-	-	-
	<u>\$ 5,136</u>	<u>\$ -</u>	<u>\$ 5,136</u>	<u>\$ 688</u>

	December 31, 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>

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 TDR's for the three and nine month periods ending September 30, 2014 and September 30, 2013.

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 period end had been recognized at original contractual rates (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Interest income that would have been recorded	\$ 114	\$ 139	\$ 350	\$ 384
Interest income recorded	23	55	73	168
Effect on interest income	<u>\$ 91</u>	<u>\$ 84</u>	<u>\$ 277</u>	<u>\$ 216</u>

The amount of additional funds committed to borrowers who are in TDR status was \$232 thousand at September 30, 2014 and \$232 thousand at December 31, 2013.

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

The Bank had no loans that were restructured within the 12 months preceding September 30, 2014 and September 30, 2013 and defaulted during the three and nine months ended September 30, 2014 and September 30, 2013.

NOTE 7 – Other Real Estate

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

	<u>Three Months Ended September 30,</u>		<u>Nine Months Ended September 30,</u>	
	<u>2014</u>	<u>2013</u>	<u>2014</u>	<u>2013</u>
Balance, beginning of period	\$ 1,753	\$ 2,966	\$ 1,056	\$ 5,131
Transfers from nonperforming loans	-	-	697	-
Transfers from premises and equipment	-	800	-	800
Real estate sold	(697)	(1,548)	(697)	(3,713)
Net gains (losses) on sale of assets	-	8	-	8
Provision	-	(40)	-	(40)
Balance, end of period	<u>\$ 1,056</u>	<u>\$ 2,186</u>	<u>\$ 1,056</u>	<u>\$ 2,186</u>

	<u>September 30,</u> <u>2014</u>	<u>December 31,</u> <u>2013</u>	<u>September 30,</u> <u>2013</u>
Other real estate	\$ 1,754	\$ 3,250	\$ 5,120
Valuation allowance	<u>(698)</u>	<u>(2,194)</u>	<u>(2,934)</u>
Other real estate, net	<u>\$ 1,056</u>	<u>\$ 1,056</u>	<u>\$ 2,186</u>

NOTE 8 – Earnings Per Share

The following table shows the amounts used in computing per share results:

	Three months ended September 30, 2014	Nine months ended September 30, 2014
Denominator for basic earnings per share:		
Average common shares outstanding	3,386,187	3,364,465
Dilutive effect of stock compensation	116,257	123,716
Denominator for diluted earnings per share	<u>3,502,444</u>	<u>3,488,181</u>
Numerator (in thousands):		
Net income	\$ 1,981	\$ 5,980
Preferred stock costs	475	1,322
Net income available to common shareholders	<u>\$ 1,506</u>	<u>\$ 4,658</u>
Basic earnings per common share	<u>\$ 0.44</u>	<u>1.38</u>
Diluted earnings per common share	<u>\$ 0.43</u>	<u>\$ 1.34</u>
	Three months ended September 30, 2013	Nine months ended September 30, 2013
Denominator for basic earnings per share:		
Average common shares outstanding	3,299,236	3,299,467
Dilutive effect of stock compensation	178,265	172,731
Denominator for diluted earnings per share	<u>3,477,501</u>	<u>3,472,198</u>
Numerator (in thousands):		
Net income	\$ 487	\$ 6,748
Preferred stock costs	330	981
Net income available to common shareholders	<u>\$ 157</u>	<u>\$ 5,767</u>
Basic earnings per common share	<u>\$ 0.05</u>	<u>\$ 1.75</u>
Diluted earnings per common share	<u>\$ 0.05</u>	<u>\$ 1.66</u>

NOTE 9 – Share-Based Compensation

The Company may grant share-based compensation at prices equal to the fair value of the stock at the grant date. 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. The plans are as follows:

	<u>1995</u>	<u>2002</u>	<u>2006</u>	<u>2010</u>	<u>Total</u>
Total Shares in Plan	250,000	125,000	200,000	250,000	825,000
Total Shares Available	48,751	-	9,850	250,000	308,601

Following is a summary of fully vested stock options and options expected to vest as of September 30, 2014:

	<u>Stock Options Outstanding</u>	<u>Stock Options Currently Exercisable</u>	<u>Stock Options Vested and Expected to Vest</u>
Number	125,800	125,800	125,800
Weighted-average exercise price	\$3.00	\$3.00	\$3.00
Weighted-average remaining contractual term	5.46 years	5.46 years	5.46 years

The stock options currently outstanding can be exercised until the expiration date of March 17, 2020.

The Company recognized share-based compensation expense of \$31,000 related to restricted stock for the three month period ended September 30, 2014, and \$87,000 for the nine month period ended September 30, 2014. The Company recognized share-based compensation expense of \$10,000 related to restricted stock for the three month period ended September 30, 2013, and \$21,000 for the nine month period ended September 30, 2013.

At September 30, 2014, the Company had \$246,000 of unamortized restricted stock compensation expense. All of this expense will be amortized by March 31, 2017. The cost of restricted stock granted is recognized over the vesting period, which is generally three or more years.

NOTE 10 – Fair Value Measurements

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. Valuation techniques include use of option pricing models, discounted cash flow models and similar techniques.

At the beginning of the period, all assets and liabilities valued at fair value on a recurring basis were considered to be Level 2. There were no transfers into or out of Level 2 during the period; however, the Company purchased US Treasury Securities during the second quarter of 2014, which are considered Level 1.

The following tables summarize the financial assets and liabilities of the Company for which fair values are determined on a recurring basis (in thousands):

	Carrying Value at September 30, 2014				Nine Months Ended September 30, 2014
	Total	Level 1	Level 2	Level 3	Total gains/(losses)
ASSETS					
Securities available for sale	\$ 456,192	\$ 11,886	\$ 444,306	\$ -	\$ 528
Loans held for sale	42,441	-	42,441	-	368
Commitments to originate mortgage loans	1,596	-	1,596	-	802
Commitments to sell mortgage loans	-	-	-	-	-
Mortgage banking short positions	-	-	-	-	-
Total assets at fair value	<u>\$ 500,229</u>	<u>\$ 11,886</u>	<u>\$ 488,343</u>	<u>\$ -</u>	<u>\$ 1,698</u>
LIABILITIES					
Commitments to sell mortgage loans	\$ 175	\$ -	\$ 175	\$ -	\$ (282)
Mortgage banking short positions	53	-	53	-	(327)
Total liabilities at fair value	<u>\$ 228</u>	<u>\$ -</u>	<u>\$ 228</u>	<u>\$ -</u>	<u>\$ (609)</u>

	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>

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

	Carrying Value at September 30, 2014				Nine Months Ended September 30, 2014
	Total	Level 1	Level 2	Level 3	Total gains/(losses)
Impaired loans ⁽¹⁾	\$ 4,506	\$ -	\$ 4,506	\$ -	\$ (54)
Other real estate ⁽²⁾	1,056	-	1,056	-	52
Total	<u>\$ 5,562</u>	<u>\$ -</u>	<u>\$ 5,562</u>	<u>\$ -</u>	<u>\$ (2)</u>
	Carrying Value at December 31, 2013				Twelve Months Ended December 31, 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	<u>\$ 4,652</u>	<u>\$ -</u>	<u>\$ 4,652</u>	<u>\$ -</u>	<u>\$ 162</u>

(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 is based upon appraised values.

At the beginning of the period, all assets and liabilities valued at fair value on a nonrecurring basis were considered to be Level 2. There were no transfers into or out of Level 2 during the period.

NOTE 11 – Fair Value of Financial Instruments

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

	Level in Fair Value Measurement Hierarchy	September 30, 2014		December 31, 2013	
		Carrying Amount	Fair Value	Carrying Amount	Fair Value
Assets:					
Cash and cash equivalents	Level 1	\$ 28,781	\$ 28,781	\$ 18,871	\$ 18,871
Investment securities available for sale	Level 1	11,886	11,886	-	-
Investment securities available for sale	Level 2	444,306	444,306	435,719	435,719
Federal Reserve Bank and Federal Home Loan Bank stock	Level 2	2,817	2,817	2,729	2,729
Loans held for sale-mortgage banking	Level 2	42,441	42,441	32,870	32,870
Commitments to originate mortgage loans	Level 2	1,596	1,596	706	706
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	326,689	327,606	308,081	308,932
Accrued interest receivable	Level 2	3,248	3,248	3,554	3,554
		<u>\$ 861,764</u>	<u>\$ 862,681</u>	<u>\$ 802,911</u>	<u>\$ 803,762</u>
Liabilities and Stockholders' Equity:					
Deposits, noninterest-bearing	Level 2	\$ 156,704	\$ 156,704	\$ 141,788	\$ 141,788
Deposits, interest-bearing	Level 2	617,562	617,036	581,441	583,626
Borrowings and advances	Level 2	23,014	23,056	19,967	19,967
Accrued interest payable	Level 2	368	368	771	771
Accrued expenses	Level 2	6,565	6,565	6,307	6,307
Commitments to sell mortgage loans	Level 2	175	175	-	-
Mortgage banking short positions	Level 2	53	53	-	-
Guaranteed preferred beneficial interests in Company's subordinated debentures	Level 2	15,018	10,135	22,432	16,908
		<u>\$ 819,459</u>	<u>\$ 814,092</u>	<u>\$ 772,706</u>	<u>\$ 769,367</u>
Net Fair Value of Financial Instruments			<u>\$ 48,590</u>		<u>\$ 34,395</u>
Financial instruments with off-balance-sheet risk:					
Commitments to extend credit	Level 2	\$ -	\$ 304	\$ -	\$ 254
Standby and commercial letters of credit	Level 2	\$ -	\$ 16	\$ -	\$ 14

NOTE 12 – Other Borrowings

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

September 30, 2014

Unsecured Borrowing Line:			
	Line	Outstanding	Available
Bank of North Dakota (1)	\$ 10,000	\$ -	\$ 10,000
US Bank (1)	10,000	-	10,000
Zions First National Bank (1)	12,000	-	12,000
Total	<u>\$ 32,000</u>	<u>\$ -</u>	<u>\$ 32,000</u>

Secured Borrowing Line:				
	Collateral Pledged	Line	Outstanding	Available
Bank of North Dakota (1)	\$ 527	\$ 422	\$ -	\$ 422
Bank of North Dakota (2)	95,035	10,000	2,300	7,700
Total	<u>\$ 95,562</u>	<u>\$ 10,422</u>	<u>\$ 2,300</u>	<u>\$ 8,122</u>

- (1) BNC National Bank Line
(2) BNCCORP, INC. Line

At September 30, 2014, the pledged collateral for the BNC National Bank line was comprised of collateralized mortgage obligations and the pledged collateral for the BNCCORP, INC. line is the common stock of BNC National Bank. The Bank of North Dakota line of credit balance of \$2.300 million accrues interest at the 1-month Federal Home Loan Bank advance rate plus 3.00% with a floor of 4.00%. The line of credit matures in the second quarter 2017.

December 31, 2013

Unsecured Borrowing Line:			
	Line	Outstanding	Available
Bank of North Dakota (1)	\$ 5,000	\$ -	\$ 5,000
US Bank (1)	10,000	-	10,000
Zions First National Bank (1)	12,000	-	12,000
Total	<u>\$ 27,000</u>	<u>\$ -</u>	<u>\$ 27,000</u>

Secured Borrowing Line:				
	Collateral Pledged	Line	Outstanding	Available
Bank of North Dakota (1)	\$ 1,397	\$ 1,118	\$ -	\$ 1,118
Total	<u>\$ 1,397</u>	<u>\$ 1,118</u>	<u>\$ -</u>	<u>\$ 1,118</u>

- (1) BNC National Bank Line

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

NOTE 13 – Guaranteed Preferred Beneficial Interest’s in Company’s Subordinated Debentures

In July 2000, BNCCORP issued \$7.5 million of subordinated debentures at a fixed rate of 12.05%. In the third quarter 2014, these subordinated debentures were redeemed and the corresponding debentures were prepaid. The debentures were redeemed using available cash and the Bank of North Dakota line of credit. Redemption costs totaling \$356 thousand were recorded in the second quarter 2014.

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 September 30, 2014 and December 31, 2013 was 1.63% and 1.65%, 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.

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

For purposes of Items 2 and 3 of this report, we refer to (we), (our) or (the Company) when such reference includes BNCCORP, INC. and its consolidated subsidiaries, collectively; (BNCCORP) when referring only to the holding company named BNCCORP, INC.; (the Bank) when referring only to BNC National Bank.

Comparison of Results for the Three and Nine Months Ended September 30, 2014 and 2013

Summary for the Three Months Ended September 30, 2014 and 2013

Net income was \$1.981 million and the net income available to common shareholders was \$1.506 million, or \$0.43 per share on a diluted basis, for the quarter ended September 30, 2014. This compared to net income of \$487 thousand and net income available to common shareholders of \$157 thousand, or \$0.05 per diluted share, in the third quarter of 2013.

Net interest income for the third quarter of 2014 was \$6.749 million, an increase of \$2.133 million, or 46.2%, from \$4.616 million in the same period of 2013. The net interest margin for the current period increased to 3.17% from 2.44% as yields on our investment securities and mortgage loans held for sale increased. Net interest income growth was fueled by increased deposits invested in loans held for investment and investment securities available for sale. Interest expense decreased, despite substantial deposit growth, as the Company was able to lower interest rates paid on deposits. The Company's redemption of \$7.5 million subordinated debentures in the third quarter of 2014 also contributed to increased net interest income in the period.

Total loans held for investment increased by \$40.5 million or 13.7% from September 30, 2013 and \$17.4 million or 5.5% from December 31, 2013. This growth resulted from strategies to increase loans held for investment that were instituted in early 2013. Favorable economic conditions in North Dakota continue to provide robust loan growth opportunities. These conditions also result in exceptional liquidity and our clients in North Dakota may be predisposed to repay loans on an accelerated basis.

Deposits continue to grow, primarily, though not exclusively, in North Dakota. Total deposits increased by \$51 million from December 31, 2013. We experienced a surge in growth in the first quarter of 2014 when deposits grew \$80 million and, as anticipated, our clients redeployed portions of these funds in the second and third quarters of 2014. These reductions were partially offset by other depository growth in the third quarter resulting in positive growth in deposit balances from the second to third quarter of 2014.

A reversal of previous provisions for credit losses increased pre-tax earnings by \$200 thousand in the third quarter of 2014. In the third quarter of 2013, the Company's provision for credit losses was \$0. This reflects the continued improvement of our credit quality as nonperforming assets declined to \$1.186 million in the third quarter of 2014 from \$5.0 million in the second quarter of 2014.

Non-interest income for the third quarter of 2014 was \$4.814 million. This compares to non-interest income of \$5.001 million for the same period in 2013, a decrease of \$187 thousand, or 3.7%. Excluding the impact of non-recurring insurance proceeds aggregating \$1.055 million in 2013, non-interest income in the third quarter of 2014 increased by \$868 thousand or 22.0%. Mortgage banking revenues increased \$360 thousand from the third quarter of 2013. While both periods mortgage revenues were impacted by increased interest rates beginning in 2013, the third quarter of 2014 benefited from the enhanced purchase mortgage loan capabilities added since the refinance downturn in the third quarter of 2013. The focus on purchase originations may result in a more seasonal business, particularly in our more northern locations. Gains on sales of SBA loans increased \$387 thousand or 128.6% to \$688 thousand in the third quarter of 2014 from \$301 thousand in the prior year third quarter.

Non-interest expense for the third quarter of 2014 was \$8.765 million compared to \$9.451 million in the same period of 2013, a decrease of \$686 thousand, or 7.3%. Excluding the impact of non-recurring impairment charge and reductions of post-retirement benefits, which netted to \$1.326 million in 2013, non-interest expense in the third quarter of 2014 increased by \$640 thousand, or 7.9%. This increase reflects increased incentive compensation estimates related to the robust loan and deposit growth in 2014.

In the third quarter of 2014, we recorded tax expense of \$1.017 million which resulted in an effective tax rate of 33.92% for the quarter. In the third quarter of 2013, we recorded a tax benefit of \$321 thousand. During the third quarter of 2014, the Company recorded increased tax expense equating to an annual effective tax rate of 32%. This adjustment results from a different mix of taxable and non-taxable income than anticipated. The effective tax rate reduction in 2014 was primarily due to the impact of increased tax exempt investments made in the second half of 2013.

Summary for the Nine Months Ended September 30, 2014 and 2013

Net income was \$5.980 million, and the income available to common shareholders was \$4.658 million, or \$1.34 per share on a diluted basis, for the nine months ended September 30, 2014. For the nine months ended September 30, 2013, net income was \$6.748 million, and the income available to common shareholders was \$5.767 million, or \$1.66 per share on a diluted basis.

Net interest income for the nine months ended September 30, 2014 was \$19.277 million, an increase of \$5.445 million, or 39.4%, from \$13.832 million in the same period of 2013. The year to date net interest margin increased to 3.11% from 2.50% as yields on our investment securities and mortgage loans held for sale increased. Net interest income growth was fueled by increased deposits invested in loans held for investment and investment securities available for sale. Interest expense decreased, despite substantial deposit growth, as the Company was able to lower interest rates paid on deposits. The Company's redemption of subordinated debentures in the third quarter of 2014 also contributed to increased net interest income in the period.

A reversal of previous provisions for credit losses increased pre-tax earnings by \$800 thousand in the first nine months of 2014. In the first nine months of 2013, the Company's provision for credit losses was \$700 thousand. The reversal in 2014 was recorded based on the Company's continued improvement in credit quality during the period as nonperforming assets decreased by \$5.5 million from year-end 2013 from \$6.7 million to \$1.2 million at September 30, 2014.

Non-interest income for the nine months ended September 30, 2014 was \$14.459 million. This compares to non-interest income of \$24.667 million for the same period in 2013, a decrease of \$10.218 million, or 41.4%. Excluding the impact of non-recurring insurance proceeds aggregating \$1.055 million in 2013, non-interest income in the first nine months of 2014 decreased by \$9.163 million or 38.8% compared to the first nine months of 2013. As noted above, while interest rate changes in 2013 have adversely impacted our year-to-date mortgage originations, our transformation from primarily refinance originations to a more balanced mix of refinance and purchase originations has been successful. Gains on sales of SBA loans were \$1.688 million for the nine month period in 2014 compared to \$1.408 million for the same period in the prior year.

Non-interest expense for the nine months ended September 30, 2014 was \$25.742 million compared to \$27.907 million, in the same period of 2013, a decrease of \$2.165 million, or 7.8%. Excluding the impact of a non-recurring impairment charge and reduction of post-retirement benefits, which netted to \$1.326 million in 2013, non-interest expense in the first nine months of 2014 decreased by \$839 thousand, or 3.2%. Non-interest expense in 2014 includes \$356 thousand of costs related to the redemption of \$7.5 million of 12.05% subordinated debentures in the third quarter of 2014. Professional services expense declined \$646 thousand in the nine month period ended September 30, 2014 due to lower legal service costs as well as lower volume related mortgage costs.

During the nine month period ended September 30, 2014, we recorded tax expense of \$2.814 million which resulted in an effective tax rate of 32% on a year-to-date basis. A tax expense of \$3.154 million was

recognized during the nine month period ended September 30, 2013, which resulted in an effective tax rate of 31.85%. During the third quarter of 2014, the Company recorded increased tax expense equating to an annual effective tax rate of 32%. This adjustment results from a different mix of taxable and non-taxable income than anticipated. The effective tax rate reduction in 2014 was primarily due to the impact of increased tax exempt investments made in the second half of 2013.

Net Interest Income

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

	Three Months Ended September 30,								
	2014			2013			Change		
	Average balance	Interest earned or owed	Average yield or cost	Average balance	Interest earned or owed	Average yield or cost	Average balance	Interest earned or owed	Average yield or cost
Interest-earning assets									
Federal funds sold/cash equivalents	\$ 32,412	\$ 19	0.23%	\$ 70,502	\$ 47	0.26%	\$ (38,090)	\$ (28)	-0.03%(a)
Investments - taxable	389,347	2,471	2.52%	322,102	1,332	1.64%	67,245	1,139	0.88%(b)
Investments - tax exempt	68,838	559	3.22%	43,500	370	3.37%	25,338	189	-0.15%(b)
Loans held for sale – mortgage banking	32,495	305	3.72%	46,872	410	3.47%	(14,377)	(105)	0.25%(c)
Loans and leases held for investment	331,554	4,186	5.01%	277,257	3,401	4.87%	54,297	785	0.14%(d)
Allowance for loan losses	(8,826)	-		(9,894)	-		1,068	-	
Total interest-earning assets	<u>\$ 845,820</u>	<u>\$ 7,540</u>	3.54%	<u>\$ 750,339</u>	<u>\$ 5,560</u>	2.94%	<u>\$ 95,481</u>	<u>\$ 1,980</u>	0.60%
Interest-bearing liabilities									
Interest checking and money market	\$ 413,584	\$ 135	0.13%	\$ 345,024	\$ 129	0.15%	\$ 68,560	\$ 6	-0.02%(e)
Savings	24,626	2	0.03%	20,027	3	0.06%	4,599	(1)	-0.03%(e)
Certificates of deposit under \$100,000	108,350	350	1.28%	125,311	383	1.21%	(16,961)	(33)	0.07%(e)
Certificates of deposit \$100,000 and over	82,618	97	0.47%	80,623	130	0.64%	1,995	(33)	-0.17%(e)
Total interest-bearing deposits	629,178	584	0.37%	570,985	645	0.45%	58,193	(61)	-0.08%
Short-term borrowings	20,564	9	0.17%	20,965	10	0.19%	(401)	(1)	-0.02%(f)
Federal Home Loan Bank advances	1	-	0.00%	-	-	0.00%	1	-	0.00%
Long-term borrowings	1,369	14	4.06%	-	-	0.00%	1,369	14	4.06%(g)
Subordinated debentures	18,890	184	3.86%	22,431	289	5.11%	(3,541)	(105)	-1.25%(h)
Total borrowings	40,824	207	2.01%	43,396	299	2.73%	(2,572)	(92)	-0.72%
Total interest-bearing liabilities	<u>\$ 670,002</u>	<u>791</u>	0.47%	<u>\$ 614,381</u>	<u>944</u>	0.61%	<u>\$ 55,621</u>	<u>(153)</u>	-0.14%
Net interest income/spread		<u>\$ 6,749</u>	3.07%		<u>\$ 4,616</u>	2.33%		<u>\$ 2,133</u>	0.74%
Net interest margin			3.17%			2.44%			0.73%(i)
Notation:									
Non-interest-bearing deposits	\$ 142,949			\$ 119,334	-		\$ 23,615	-	
Total deposits	<u>\$ 772,127</u>	<u>\$ 584</u>	0.30%	<u>\$ 690,319</u>	<u>\$ 645</u>	0.37%	<u>\$ 81,808</u>	<u>\$ (61)</u>	-0.07%
Taxable equivalents:									
Total interest-earning assets	\$ 845,820	\$ 7,840	3.68%	\$ 750,339	\$ 5,754	3.04%	\$ 95,481	\$ 2,086	0.64%
Net interest income/spread	-	\$ 7,049	3.21%	-	\$ 4,810	2.43%	-	\$ 2,239	0.78%
Net interest margin	-	-	3.31%	-	-	2.54%	-	-	0.77%(i)

- (a) Cash balances can fluctuate significantly, but we generally emphasize liquidity.
- (b) Investment growth has been funded by an increase in deposits and redeployment of cash from reduced mortgage loans held for sale.
- (c) Loans held for sale decreased from the prior year; however, 2014 purchased home loan originations have partially replenished 2013 refinance production in 2014.
- (d) The balance of loans held for investment has risen due to increased activity in our core market areas. Early in 2013, we implemented measures to increase our loans held for investment and continue to gain traction considering the liquidity in the market place. Loan balances, however, continue to be subject to unscheduled repayments due to the present excess liquidity in the North Dakota economic region.

- (e) Total deposits can vary depending on the cash needs of our customers; our balances in these accounts have increased due to growth, primarily in North Dakota. Deposit balances surged upward on March 31, 2014 by \$80 million. Customers redeployed a portion of those balances in the second and third quarters of 2014. Interest expense has declined despite significant balance growth as the Company has been able to lower the rates paid on deposits.
- (f) Short-term borrowings will vary depending on our customers need to use repurchase agreements and the Company's decision to utilize its lines of credit for various business purposes.
- (g) The Company borrowed \$2.7 million to partially finance the subordinated debenture redemption and subsequently paid down \$400 thousand in the third quarter 2014.
- (h) The Company redeemed \$7.5 million of subordinated debentures in the third quarter of 2014.
- (i) Net interest margin has increased as rising low cost deposit balances are deployed in investment securities and loans. Loans held for investment yields have remained steady while investment and mortgage loan yields have increased in 2014 compared to 2013.

Nine Months Ended September 30,

	2014			2013			Change		
	Average balance	Interest earned or owed	Average yield or cost	Average balance	Interest earned or owed	Average yield or cost	Average balance	Interest earned or owed	Average yield or cost
Interest-earning assets									
Federal funds sold/cash equivalents	\$ 35,158	\$ 58	0.22%	\$ 66,483	\$ 127	0.26%	\$ (31,325)	\$ (69)	-0.04%(a)
Investments - taxable	381,034	7,348	2.58%	295,973	3,969	1.79%	85,061	3,379	0.79%(b)
Investments - tax exempt	66,300	1,658	3.34%	40,463	947	3.13%	25,837	711	0.21%(b)
Loans held for sale – mortgage banking	28,215	799	3.79%	66,411	1,585	3.19%	(38,196)	(786)	0.60%(c)
Loans and leases held for investment	328,464	12,053	4.91%	278,884	10,141	4.86%	49,580	1,912	0.05%(d)
Allowance for loan losses	(9,370)	-		(9,951)	-		581	-	
Total interest-earning assets	<u>\$ 829,801</u>	<u>\$ 21,916</u>	3.53%	<u>\$ 738,263</u>	<u>\$ 16,769</u>	3.04%	<u>\$ 91,538</u>	<u>\$ 5,147</u>	0.49%
Interest-bearing liabilities									
Interest checking and money market	\$ 402,554	\$ 404	0.13%	\$ 338,145	\$ 452	0.18%	\$ 64,409	\$ (48)	-0.05%(e)
Savings	24,107	7	0.04%	19,483	12	0.08%	4,624	(5)	-0.04%(e)
Certificates of deposit under \$100,000	115,799	1,093	1.26%	126,319	1,163	1.23%	(10,520)	(70)	0.03%(e)
Certificates of deposit \$100,000 and over	81,743	333	0.54%	79,964	411	0.69%	1,779	(78)	-0.15%(e)
Total interest-bearing deposits	624,203	1,837	0.39%	563,911	2,038	0.48%	60,292	(201)	-0.09%
Short-term borrowings	20,069	27	0.18%	17,634	30	0.23%	2,435	(3)	-0.05%(f)
Federal Home Loan Bank advances	566	1	0.24%	-	-	0.00%	566	1	0.24%
Long-term borrowings	456	14	4.10%	-	-	0.00%	456	14	4.10%(g)
Subordinated debentures	21,252	760	4.78%	22,431	869	5.18%	(1,179)	(109)	-0.40%(h)
Total borrowings	42,343	802	2.53%	40,065	899	3.00%	2,278	(97)	-0.47%
Total interest-bearing liabilities	<u>\$ 666,546</u>	<u>2,639</u>	0.53%	<u>\$ 603,976</u>	<u>2,937</u>	0.65%	<u>\$ 62,570</u>	<u>(298)</u>	-0.12%
Net interest income/spread		<u>\$ 19,277</u>	3.00%		<u>\$ 13,832</u>	2.39%		<u>\$ 5,445</u>	0.61%
Net interest margin			3.11%			2.50%			0.61%(i)
Notation:									
Non-interest-bearing deposits	<u>\$ 135,535</u>	-		<u>\$ 115,334</u>	-		<u>\$ 20,201</u>	-	
Total deposits	<u>\$ 759,738</u>	<u>\$ 1,837</u>	0.32%	<u>\$ 679,245</u>	<u>\$ 2,038</u>	0.40%	<u>\$ 80,493</u>	<u>\$ (201)</u>	-0.08%
Taxable equivalents:									
Total interest-earning assets	\$ 829,801	\$ 22,787	3.67%	\$ 738,263	\$ 17,266	3.13%	\$ 91,538	\$ 5,521	0.54%
Net interest income/spread	-	\$ 20,148	3.14%	-	\$ 14,329	2.48%	-	\$ 5,819	0.66%
Net interest margin	-	-	3.25%	-	-	2.59%	-	-	0.66%(i)

- (a) Cash balances can fluctuate significantly, but we generally emphasize liquidity.
- (b) Investment growth has been funded by an increase in deposits and redeployment of cash from reduced mortgage loans held for sale.
- (c) Loans held for sale declined as production was reduced due to an increase in interest rates that began in 2013.
- (d) The balance of loans held for investment has risen due to increased activity in our core market areas. Early in 2013, we implemented measures to increase our loans held for investment and continue to gain traction considering the liquidity in the market place. Loan balances, however, are subject to unscheduled repayments due to the present excess liquidity in the North Dakota economic region.
- (e) Total deposits can vary depending on the cash needs of our customers; our balances in these accounts have increased due to growth, primarily in North Dakota. Deposit balances surged upward on March 31, 2014 by \$80 million. Customers redeployed a portion of those balances in the second and third quarters of 2014. Interest expense has declined despite significant balance growth as the Company has been able to lower the rates paid on deposits.
- (f) Short-term borrowings will vary depending on our customers need to use repurchase agreements and the Company's decision to utilize its lines of credit for various business purposes.
- (g) The Company borrowed \$2.7 million to partially finance the subordinated debentures redemption, and subsequently paid down \$400 thousand in the third quarter of 2014.
- (h) The Company redeemed \$7.5 million of subordinated debentures in the third quarter of 2014.
- (i) Net interest margin has increased as rising low cost deposit balances are deployed in investment securities and loans. Loans held for investment yields have remained steady while investment and mortgage loan yields have increased in 2014 compared to 2013.

Non-interest Income

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

	Three Months Ended				Nine Months Ended			
	September 30,		Increase (Decrease)		September 30,		Increase (Decrease)	
	2014	2013	\$	%	2014	2013	\$	%
Bank charges and service fees	\$ 743	\$ 698	\$ 45	6 %	\$ 2,114	\$ 1,989	\$ 125	6 % (a)
Wealth management revenues	331	302	29	10 %	1,066	935	131	14 % (b)
Mortgage banking revenues	2,782	2,422	360	15 %	8,455	17,413	(8,958)	(51) % (c)
Gains on sales of loans, net	688	301	387	129 %	1,688	1,408	280	20 % (d)
Gains on sales of securities, net	-	37	(37)	100 %	528	1,247	(719)	(58) % (e)
Other	270	186	84	45 %	608	630	(22)	(3) %
Subtotal non-interest income	4,814	3,946	868	22 %	14,459	23,622	(9,163)	(39) %
Life insurance benefit received	-	1,055	(1,055)	(100) %	-	1,055	(1,055)	(100) % (f)
Total non-interest income	<u>\$ 4,814</u>	<u>\$ 5,001</u>	<u>\$ (187)</u>	(4) %	<u>\$ 14,459</u>	<u>\$ 24,677</u>	<u>\$ (10,218)</u>	(41) %

- (a) These fees are growing as we continue to grow deposits and open new accounts.
(b) Wealth management revenues continue to grow as our North Dakota customers increase utilization of our wealth management services.
(c) On a year-to-date basis, mortgage banking revenues declined as interest rate increases starting in 2013 negatively impacted refinance origination volume. In the second and third quarters of 2014, purchase originations have contributed a greater percentage to mortgage revenue than in the prior year.
(d) Gains and losses on sales of loans will vary significantly from period to period. The secondary market for SBA loans currently remains acquisitive and loans can be sold at attractive prices.
(e) Gains and losses on sales of securities will vary significantly from period to period.
(f) In the third quarter of 2013, the Company recognized life insurance benefits of \$1.055 million.

Non-interest Expense

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

	Three Months Ended				Nine Months Ended			
	September 30,		Increase (Decrease)		September 30,		Increase (Decrease)	
	2014	2013	\$	%	2014	2013	\$	%
Salaries and employee benefits	\$ 4,435	\$ 3,811	\$ 624	16 %	\$ 13,217	\$ 13,165	\$ 52	0 % (a)
Professional services	848	861	(13)	(2) %	2,237	2,883	(646)	(22) % (b)
Data processing fees	745	717	28	4 %	2,183	2,218	(35)	(2) %
Marketing and promotion	813	718	95	13 %	2,121	1,927	194	10 % (c)
Occupancy	588	597	(9)	(2) %	1,561	1,765	(204)	(12) %
Regulatory costs	158	146	12	8 %	466	680	(214)	(31) % (d)
Depreciation and amortization	315	311	4	1 %	922	928	(6)	(1) %
Office supplies and postage	156	139	17	12 %	495	461	34	7 %
Other real estate costs	27	38	(11)	(29) %	59	164	(105)	(64) % (e)
Other	680	787	(107)	(14) %	2,481	2,390	91	4 % (f)
Subtotal non-interest expense	8,765	8,125	640	8 %	25,742	26,581	(839)	(3) %
Impairment charge	-	1,500	(1,500)	(100) %	-	1,500	(1,500)	(100) % (g)
Post retirement benefits reduction	-	(174)	174	(100) %	-	(174)	174	(100) % (h)
Total non-interest expense	<u>\$ 8,765</u>	<u>\$ 9,451</u>	<u>\$ (686)</u>	(7) %	<u>\$ 25,742</u>	<u>\$ 27,907</u>	<u>\$ (2,165)</u>	(8) %
Efficiency ratio	<u>75.8%</u>	<u>98.3%</u>			<u>76.3%</u>	<u>72.5%</u>		

- (a) Incentive accruals were increased in the third quarter of 2014 in light of indications of strong loan and deposit growth.
(b) Professional services decreased in mortgage banking as our volumes decreased.
(c) Marketing costs have increased for the banking and mortgage banking operations to drive volume.

- (d) The nine months ended September 30, 2014 decrease is due to lower regulatory assessments in the first half of 2014. In the third quarter 2014, costs increased relative to 2013 third quarter due to the significant increase in average assets in 2014.
- (e) Other real estate costs will vary from period to period depending on valuation adjustments and maintenance costs on our foreclosed properties— see Note 7.
- (f) Other expense in the second quarter of 2014 includes \$356 thousand of costs related to the redemption of \$7.5 million of subordinated debentures.
- (g) In the third quarter of 2013, the Company 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.
- (h) Post retirement benefits were reversed in 2013 when benefit eligibility ceased for one individual.

Income Taxes

In the third quarter of 2014, we recorded tax expense of \$1.017 million which resulted in an effective tax rate of 33.92% for the quarter. In the third quarter of 2013, we recorded a tax benefit of \$321 thousand. During the third quarter 2014, the Company recorded increased tax expense equating to an annual effective tax rate of 32%. This adjustment results from a different mix of taxable and non-taxable income than anticipated. The effective tax rate reduction in 2014 was primarily due to the impact of increased tax exempt investments made in the second half of 2013.

Comparison of Financial Condition at September 30, 2014 and December 31, 2013

Assets

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

	September 30,	December 31,	Increase (Decrease)		
	2014	2013	\$	%	
Cash and cash equivalents	\$ 28,781	\$ 18,871	\$ 9,910	53	% (a)
Investment securities available for sale	456,192	435,719	20,473	5	%
Federal Reserve Bank and Federal Home Loan Bank of Des Moines stock	2,817	2,729	88	3	%
Loans held for sale-mortgage banking	42,441	32,870	9,571	29	% (b)
Loans and leases held for investment, net	335,364	317,928	17,436	5	% (c)
Allowance for credit losses	(8,675)	(9,847)	1,172	(12)	% (d)
Other real estate, net	1,056	1,056	-	-	% (e)
Premises and equipment, net	15,819	14,870	949	6	%
Accrued interest receivable	3,248	3,554	(306)	(9)	%
Other assets	22,677	25,373	(2,696)	(11)	% (f)
Total assets	<u>\$ 899,720</u>	<u>\$ 843,123</u>	<u>\$ 56,597</u>	7	%

- (a) Cash balances can fluctuate significantly, but we generally emphasize liquidity. Balances were elevated as of September 30, 2014 due to an increase in customer deposits and loan payoffs.
- (b) Loans held for sale increased from year end 2013 due to the successful transition to a purchase origination business model as well as seasonality associated with this model.
- (c) The balance of loans held for investment has increased due to increased activity in our core market areas. Early in 2013, we implemented measures to increase our loans held for investment and continue to gain traction considering the liquidity in the market place.
- (d) The allowance for credit losses decreased primarily due to a \$800 thousand reversal of previous provisions and \$673 thousand of loan balances charged off as the Company continued to manage non-accrual loans.
- (e) See Note 7 for further detail on changes in other real estate.
- (f) The decrease relates primarily to the utilization of deferred tax assets.

Loan Participations

Pursuant to our lending policy, loans may not exceed 85 percent of the Bank's legal lending limit (except to the extent collateralized by U.S. Treasury securities or Bank deposits) unless the Bank's Chief Credit Officer or the Executive Credit Committee grant prior approval. To accommodate creditworthy customers whose financing needs exceed lending limits and internal restrictions, the Bank sells loan participations to outside participants without recourse. Loan participations sold on a nonrecourse basis to outside financial institutions were \$185.7 million as of September 30, 2014 and \$222.8 million as of December 31, 2013. The sales of participations are accounted for pursuant to FASB ASC 860, *Transfers and Servicing*.

Concentrations of Credit

The following table summarizes the locations and balances of our borrowers (dollars are in thousands):

	<u>September 30, 2014</u>			<u>December 31, 2013</u>		
North Dakota	\$ 210,847	63 %		\$ 206,315	65 %	
Minnesota	32,450	10		32,198	10	
Arizona	41,808	12		34,043	11	
Other	50,366	15		45,452	14	
Total gross loans held for investment	<u>\$ 335,471</u>	<u>100 %</u>		<u>\$ 318,008</u>	<u>100 %</u>	

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

	<u>September 30, 2014</u>			<u>December 31, 2013</u>		
North Dakota	\$ 224,776	67 %		\$ 211,789	67 %	
Arizona	57,829	17		43,750	14	
California	15,824	5		18,314	6	
Minnesota	11,189	3		16,372	5	
Colorado	8,915	3		9,164	3	
Wisconsin	5,512	2		5,787	2	
Other	11,426	3		12,832	3	
Total gross loans held for investment	<u>\$ 335,471</u>	<u>100 %</u>		<u>\$ 318,008</u>	<u>100 %</u>	

Loan Maturities⁽¹⁾

The following table sets forth the remaining maturities of loans in each major category of our portfolio as of September 30, 2014 (in thousands):

	Over 1 year through 5 years			Over 5 years		Total Loans and Leases Held for Investment
	One year or less	Fixed Rate	Floating Rate	Fixed Rate	Floating rate	
Commercial and industrial	\$ 43,270	\$ 15,933	\$ 3,598	\$ 32,631	\$ 24,651	\$ 120,083
Commercial real estate	17,931	12,497	10,120	13,197	48,107	101,852
SBA	7,502	46	1,649	2,342	14,054	25,593
Consumer	1,558	3,827	2,839	23,715	3,840	35,779
Land and land development	500	5,283	8,762	4,017	7,673	26,235
Construction	18,679	397	6,853	-	-	25,929
Total principal amount of loans	<u>\$ 89,440</u>	<u>\$ 37,983</u>	<u>\$ 33,821</u>	<u>\$ 75,902</u>	<u>\$ 98,325</u>	<u>\$ 335,471</u>

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

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

Allocation of the Allowance for Credit Losses

The table below presents, for the periods indicated, the 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 (dollars are in thousands).

	September 30, 2014		December 31, 2013	
	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	\$ 2,960	36%	\$ 2,215	42%
Commercial real estate	1,894	30%	4,041	29%
SBA	1,321	7%	579	6%
Consumer	525	11%	478	10%
Land and land development	1,653	8%	2,371	9%
Construction	322	8%	163	4%
Total	<u>\$ 8,675</u>	<u>100%</u>	<u>\$ 9,847</u>	<u>100%</u>

We do not originate sub-prime single family loans. We do have land, construction, and commercial real estate loans in our portfolio. We continue to closely monitor all loans, but particularly those in deteriorating industries.

Nonperforming Loans

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2014	2013	2014	2013
Balance, beginning of period	\$ 3,251	\$ 10,183	\$ 5,617	\$ 10,512
Additions to nonperforming	119	74	198	811
Charge-offs	(7)	(5)	(680)	(909)
Reclassified back to performing	(3,177)	(12)	(3,177)	(19)
Principal payment received	(56)	(111)	(1,131)	(242)
Transferred to repossessed assets	-	-	-	(24)
Transferred to other real estate owned	-	-	(697)	-
Balance, end of period	<u>\$ 130</u>	<u>\$ 10,129</u>	<u>\$ 130</u>	<u>\$ 10,129</u>

Nonperforming Assets

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

	September 30, 2014	December 31, 2013
Nonperforming loans:		
Loans 90 days or more delinquent and still accruing interest	\$ 18	\$ 961
Non-accrual loans	112	4,656
Total nonperforming loans	130	5,617
Other real estate, net	1,056	1,056
Total nonperforming assets	<u>\$ 1,186</u>	<u>\$ 6,673</u>
Allowance for credit losses	<u>\$ 8,675</u>	<u>\$ 9,847</u>
Ratio of total nonperforming loans to total loans	0.03%	1.60%
Ratio of total nonperforming loans to loans and leases held for investment	0.04%	1.77%
Ratio of total nonperforming assets to total assets	0.13%	0.79%
Ratio of nonperforming loans to total assets	0.01%	0.67%
Ratio of allowance for credit losses to nonperforming loans	6,673%	175%

Potential Problem Loans

We attempt to quantify potential problem loans with more immediate credit risk. At September 30, 2014, the Bank had \$9.5 million of classified loans and \$112 thousand of loans on non-accrual. This compares to \$13.5 million of classified loans and \$4.7 million of loans on non-accrual at December 31, 2013 and \$13.0 million of classified loans and \$10.1 million of loans on non-accrual at September 30, 2013. We estimate there are loans risk rated “watch list” which are not impaired aggregating \$166 thousand at September 30, 2014 and \$176 thousand at December 31, 2013. Also, we estimate there are loans risk rated “substandard” which are not impaired aggregating \$9.4 million at September 30, 2014 and \$8.1 million at December 31, 2013.

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

Other Real Estate

See Note 7 included in the quarterly report.

Liabilities

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

Liabilities	September 30,	December 31,	Increase (Decrease)		
	2014	2013	\$	%	
Deposits:					
Non-interest-bearing	\$ 156,704	\$ 141,788	\$ 14,916	11 %	(a)
Interest-bearing-					
Savings, interest checking and money market	427,504	378,355	49,149	13 %	(a)
Time deposits under \$100,000	110,578	123,058	(12,480)	(10) %	(a)
Time deposits \$100,000 and over	79,480	80,028	(548)	(1) %	(a)
Short-term borrowings	20,714	19,967	747	4 %	(b)
Long-term borrowings	2,300	-	2,300	100 %	(c)
Guaranteed preferred beneficial interests in Company's subordinated debentures	15,018	22,432	(7,414)	(33) %	(d)
Accrued interest payable	368	771	(403)	(52) %	
Accrued expenses	6,565	6,307	258	4 %	(e)
Other liabilities	733	552	181	33 %	(f)
Total liabilities	<u>\$ 819,964</u>	<u>\$ 773,258</u>	<u>\$ 46,706</u>	6 %	

- (a) Total deposits have increased primarily due to growth in our North Dakota branches. Balances were elevated at March 31, 2014 due to an increase in customer deposits late in the first quarter of 2014. Customers have redeployed a portion of these deposits in the second and third quarters of 2014.
- (b) Short-term borrowings will vary depending on our customers need to use repurchase agreements or the Company's decision to utilize its lines of credit for various business purposes.
- (c) The Company borrowed from the Bank of North Dakota line of credit to partially fund the subordinated debenture redemption in the third quarter of 2014.
- (d) The Company redeemed \$7.5 million of subordinated debentures in the third quarter of 2014.
- (e) Accrued expenses increased primarily due to incentive compensation related to loan and deposit growth in 2014.
- (f) Other liabilities increased primarily due to an increase in mortgage banking derivatives.

Mortgage Banking Obligations

Included in accrued expenses is an estimate of mortgage banking reimbursement obligations which aggregated \$1.7 million at September 30, 2014 and December 31, 2013. 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 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. The following is a summary of activity related to mortgage banking obligations (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Balance, beginning of period	\$ 1,577	\$ 1,702	\$ 1,679	\$ 1,500
Provision	120	200	318	568
Write offs, net	(11)	(361)	(311)	(527)
Balance, end of period	<u>\$ 1,686</u>	<u>\$ 1,541</u>	<u>\$ 1,686</u>	<u>\$ 1,541</u>

Stockholders' Equity

Our stockholders' equity increased \$9.9 million between December 31, 2013 and September 30, 2014 primarily due to \$4.7 million in additional retained earnings and an increase in unrealized gains and losses in our investment portfolio of \$5.1 million.

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 (\$252.5 million as of September 30, 2014);
2. Borrowing capacity from the FHLB (\$62.9 million as of September 30, 2014); and
3. Capacity to issue brokered deposits with maturities of less than 12 months (\$127.1 million as of September 30, 2014).
4. Borrowing capacity from a line of credit with Bank of North Dakota (\$7.7 million as of September 30, 2014).

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.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

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

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. 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 2 of our Consolidated Financial Statements for a summary of our accounting policies pertaining to such instruments.

Our primary tool for measuring and managing interest rate risk is net interest income simulation. This exercise includes our assumptions regarding the changes in interest rates and the impact on our current balance sheet. Interest rate caps and floors are included to the extent that they are exercised in the 12-month simulation period. Additionally, changes in prepayment behavior of the residential mortgage, CMOs, and mortgage-backed securities portfolios in each rate environment are captured using industry estimates of prepayment speeds for various coupon segments of the portfolio. For purposes of this simulation, projected month end balances of the various balance sheet accounts are held constant at their September 30, 2014 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 September 30, 2014 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 September 30, 2014, 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 results for the 12-month horizon are shown below (dollars are in thousands):

Net Interest Income Simulation						
Movement in interest rates	<u>-100bp</u>	<u>Unchanged</u>	<u>+100bp</u>	<u>+200bp</u>	<u>+300bp</u>	<u>+400bp</u>
Projected 12-month net interest income	\$ 24,544	\$ 25,567	\$ 25,448	\$ 25,226	\$ 24,912	\$ 24,599
Dollar change from unchanged scenario	\$ (1,023)	\$ -	\$ (119)	\$ (341)	\$ (655)	\$ (968)
Percentage change from unchanged scenario	(4.00)%	-	(0.47)%	(1.33)%	(2.56)%	(3.79)%

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 September 30, 2014 (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 September 30, 2014. 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 September 30, 2014

	0-3 months	4-12 Months	1-5 Years	Over 5 years	Total
(dollars are in thousands)					
Interest-earning assets:					
Interest-bearing deposits with banks	\$ 28,781	\$ -	\$ -	\$ -	\$ 28,781
Investment securities (a)	58,610	38,609	178,312	153,572	429,103
FRB and FHLB stock	2,817	-	-	-	2,817
Fed funds sold	-	-	-	-	-
Loans held for sale-mortgage banking, fixed rate	-	42,441	-	-	42,441
Loans held for sale-mortgage banking, floating rate	-	-	-	-	-
Loans held for investment, fixed rate	26,837	37,296	64,567	28,257	156,957
Loans held for investment, floating rate	94,933	7,066	73,257	3,151	178,407
Total interest-earning assets	<u>\$ 211,978</u>	<u>\$ 125,412</u>	<u>\$ 316,136</u>	<u>\$ 184,980</u>	<u>\$ 838,506</u>
Interest-bearing liabilities:					
Interest checking and money market accounts	\$ 403,643	\$ -	\$ -	\$ -	\$ 403,643
Savings	23,861	-	-	-	23,861
Time deposits under \$100,000	15,054	24,717	41,254	29,553	110,578
Time deposits \$100,000 and over	44,132	23,284	11,560	504	79,480
Short-term borrowings	20,714	-	-	-	20,714
FHLB advances	-	-	-	-	-
Other borrowing	2,300	-	-	-	2,300
Subordinated debentures	15,000	-	-	18	15,018
Total interest-bearing liabilities	<u>\$ 524,704</u>	<u>\$ 48,001</u>	<u>\$ 52,814</u>	<u>\$ 30,075</u>	<u>\$ 655,594</u>
Interest rate gap	<u>\$ (312,726)</u>	<u>\$ 77,411</u>	<u>\$ 263,322</u>	<u>\$ 154,905</u>	<u>\$ 182,912</u>
Cumulative interest rate gap at September 30, 2014	<u>\$ (312,726)</u>	<u>\$ (235,315)</u>	<u>\$ 28,007</u>	<u>\$ 182,912</u>	
Cumulative interest rate gap to total assets	(34.76)%	(26.15)%	3.11%	20.33%	

(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 September 30, 2014 and do not contemplate any actions we might undertake in response to changes in market interest rates.

Other Information

Item 1. Legal Proceedings

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

Signatures

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

BNCCORP, INC.

Date: November 26, 2014

By: /s/ Timothy J. Franz
Timothy J. Franz
President and Chief Executive Officer

By: /s/ Daniel J. Collins
Daniel J. Collins
Chief Financial Officer