# Quarterly Report

**For the quarter ended September 30, 2016**

# BNCCORP, INC.

**(OTCQX: BNCC)**

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**BNCCORP, INC.**
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# FINANCIAL INFORMATION

## Financial Statements

**BNCCORP, INC. AND SUBSIDIARIES**
Consolidated Balance Sheets
(In thousands, except share data)

| | September 30, 2016 | December 31, 2015 |
|---|---|---|
| **ASSETS** | (unaudited) | |
| CASH AND CASH EQUIVALENTS | $ 11,265 | $ 15,189 |
| INVESTMENT SECURITIES AVAILABLE FOR SALE | 409,719 | 419,346 |
| FEDERAL RESERVE BANK AND FEDERAL HOME LOAN BANK STOCK | 5,211 | 3,219 |
| LOANS HELD FOR SALE-MORTGAGE BANKING | 63,614 | 50,445 |
| LOANS AND LEASES HELD FOR INVESTMENT | 413,151 | 379,903 |
| ALLOWANCE FOR CREDIT LOSSES | (8,684) | (8,611) |
| Net loans and leases held for investment | 404,467 | 371,292 |
| OTHER REAL ESTATE, net | 225 | 242 |
| PREMISES AND EQUIPMENT, net | 19,055 | 17,574 |
| ACCRUED INTEREST RECEIVABLE | 3,677 | 4,027 |
| OTHER | 25,360 | 22,912 |
| Total assets | $ 942,593 | $ 904,246 |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | | |
| DEPOSITS: | | |
| Non-interest-bearing | $ 150,051 | $ 168,259 |
| Interest-bearing – | | |
| Savings, interest checking and money market | 453,837 | 460,385 |
| Time deposits under $100,000 | 59,511 | 86,817 |
| Time deposits $100,000 and over | 91,965 | 64,988 |
| Total deposits | 755,364 | 780,449 |
| SHORT-TERM BORROWINGS | 15,227 | 13,851 |
| FEDERAL HOME LOAN BANK ADVANCES | 58,000 | 7,300 |
| LONG-TERM BORROWINGS | 10,000 | 10,000 |
| GUARANTEED PREFERRED BENEFICIAL INTERESTS IN COMPANY'S SUBORDINATED DEBENTURES | 15,014 | 15,015 |
| ACCRUED INTEREST PAYABLE | 729 | 487 |
| ACCRUED EXPENSES | 8,265 | 7,398 |
| OTHER | 2,151 | 758 |
| Total liabilities | 864,750 | 835,258 |
| STOCKHOLDERS' EQUITY: | | |
| Common stock, $.01 par value – Authorized 35,000,000 shares; 3,458,261 and 3,428,416 shares issued and outstanding | 35 | 34 |
| Capital surplus – common stock | 25,663 | 25,979 |
| Retained earnings | 47,881 | 42,172 |
| Treasury stock (199,392 and 240,237 shares, respectively) | (2,732) | (3,278) |
| Accumulated other comprehensive income, net | 6,996 | 4,081 |
| Total stockholders' equity | 77,843 | 68,988 |
| Total liabilities and stockholders' equity | $ 942,593 | $ 904,246 |

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, 2016 | For the Three Months Ended September 30, 2015 | For the Nine Months Ended September 30, 2016 | For the Nine Months Ended September 30, 2015 |
|---|---|---|---|---|
| INTEREST INCOME: | | | | |
| Interest and fees on loans | $ 5,257 | $ 4,625 | $ 15,221 | $ 13,992 |
| Interest and dividends on investments | | | | |
| Taxable | 1,440 | 1,319 | 4,554 | 4,916 |
| Tax-exempt | 665 | 689 | 2,030 | 1,995 |
| Dividends | 46 | 29 | 124 | 89 |
| Total interest income | 7,408 | 6,662 | 21,929 | 20,992 |
| INTEREST EXPENSE: | | | | |
| Deposits | 469 | 486 | 1,682 | 1,650 |
| Short-term borrowings | 5 | 6 | 16 | 20 |
| Federal Home Loan Bank advances | 63 | 1 | 137 | 8 |
| Long-term borrowings | 159 | - | 475 | - |
| Subordinated debentures | 80 | 64 | 229 | 186 |
| Total interest expense | 776 | 557 | 2,539 | 1,864 |
| Net interest income | 6,632 | 6,105 | 19,390 | 19,128 |
| PROVISION (REDUCTION) FOR CREDIT LOSSES: | 400 | (400) | 800 | (400) |
| Net interest income after provision (reduction) for credit losses | 6,232 | 6,505 | 18,590 | 19,528 |
| NON-INTEREST INCOME: | | | | |
| Bank charges and service fees | 700 | 761 | 2,063 | 2,185 |
| Wealth management revenues | 373 | 355 | 1,156 | 1,127 |
| Mortgage banking revenues, net | 6,163 | 3,663 | 15,892 | 13,147 |
| Gains on sales of loans, net | 10 | 133 | 233 | 705 |
| Gains on sales of securities, net | 292 | 172 | 729 | 1,732 |
| Other | 221 | 148 | 832 | 727 |
| Total non-interest income | 7,759 | 5,232 | 20,905 | 19,623 |
| NON-INTEREST EXPENSE: | | | | |
| Salaries and employee benefits | 5,619 | 4,317 | 16,400 | 14,996 |
| Professional services | 1,236 | 1,039 | 3,460 | 2,891 |
| Data processing fees | 932 | 788 | 2,739 | 2,290 |
| Marketing and promotion | 924 | 1,044 | 2,826 | 2,600 |
| Occupancy | 551 | 507 | 1,620 | 1,457 |
| Regulatory costs | 168 | 176 | 502 | 523 |
| Depreciation and amortization | 397 | 358 | 1,118 | 1,062 |
| Office supplies and postage | 164 | 153 | 513 | 492 |
| Other real estate costs | - | 1 | 22 | 16 |
| Other | 727 | 597 | 1,992 | 1,977 |
| Total non-interest expense | 10,718 | 8,980 | 31,192 | 28,304 |
| Income before income taxes | 3,273 | 2,757 | 8,303 | 10,847 |
| Income tax expense | 1,014 | 882 | 2,594 | 3,471 |
| Net income | 2,259 | 1,875 | 5,709 | 7,376 |
| Preferred stock costs | - | 475 | - | 1,424 |
| Net income available to common shareholders | $ 2,259 | $ 1,400 | $ 5,709 | $ 5,952 |
| Basic earnings per common share | $ 0.65 | $ 0.41 | $ 1.66 | $ 1.76 |
| Diluted earnings per common share | $ 0.64 | $ 0.40 | $ 1.62 | $ 1.70 |

See accompanying notes to consolidated financial statements.

**BNCCORP, INC. AND SUBSIDIARIES**

Consolidated Statements of Comprehensive Income

(In thousands, unaudited)

| | For the Three Months Ended September 30, | | | | For the Nine Months Ended September 30, | | | |
|---|---|---|---|---|---|---|---|---|
| | 2016 | | 2015 | | 2016 | | 2015 | |
| NET INCOME | | $ 2,259 | | $ 1,875 | | $ 5,709 | | $ 7,376 |
| Unrealized (loss) gain on securities available for sale | $ (2,197) | | $ 2,582 | | $ 5,431 | | $ 1,996 | |
| Reclassification adjustment for gains included in net income | (292) | | (172) | | (729) | | (1,732) | |
| Other comprehensive (loss) income before tax | (2,489) | | 2,410 | | 4,702 | | 264 | |
| Income tax benefit (expense) related to items of other comprehensive income (loss) | 946 | | (916) | | (1,787) | | (100) | |
| Other comprehensive (loss) income | $ (1,543) | (1,543) | $ 1,494 | 1,494 | $ 2,915 | 2,915 | $ 164 | 164 |
| TOTAL COMPREHENSIVE INCOME | | $ 716 | | $ 3,369 | | $ 8,624 | | $ 7,540 |

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 Surplus Common | Retained | Treasury | Accumulated Other Comprehensive | |
|---|---|---|---|---|---|---|---|---|---|
| | Shares | Amount | Shares | Amount | Stock | Earnings | Stock | Income | Total |
| BALANCE, December 31, 2014 | 21,098 | $ 21,098 | 3,413,854 | $ 34 | $ 25,831 | $ 34,622 | $ (3,421) | $ 5,324 | $ 83,488 |
| Net income | - | - | - | - | - | 7,376 | - | - | 7,376 |
| Other comprehensive income | - | - | - | - | - | - | - | 164 | 164 |
| Dividend on preferred stock | - | - | - | - | - | (1,424) | - | - | (1,424) |
| Impact of share-based compensation | - | - | (1,870) | - | 89 | - | (36) | - | 53 |
| BALANCE, September 30, 2015 | 21,098 | $ 21,098 | 3,411,984 | $ 34 | $ 25,920 | $ 40,574 | $ (3,457) | $ 5,488 | $ 89,657 |
| | | | | | | | | | |
| BALANCE, December 31, 2015 | - | $ - | 3,428,416 | $ 34 | $ 25,979 | $ 42,172 | $ (3,278) | $ 4,081 | $ 68,988 |
| Net income | - | - | - | - | - | 5,709 | - | - | 5,709 |
| Other comprehensive income | - | - | - | - | - | - | - | 2,915 | 2,915 |
| Impact of share-based compensation | - | - | 29,845 | 1 | (316) | - | 546 | - | 231 |
| BALANCE, September 30, 2016 | - | $ - | 3,458,261 | $ 35 | $ 25,663 | $ 47,881 | $ (2,732) | $ 6,996 | $ 77,843 |

See accompanying notes to consolidated financial statements.

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

| | 2016 | 2015 |
|---|---|---|
| OPERATING ACTIVITIES: | | |
| Net income | $ 5,709 | $ 7,376 |
| Adjustments to reconcile net income to net cash provided by operating activities - | | |
| Provision (reduction) for credit losses | 800 | (400) |
| Provision for other real estate losses | 17 | 14 |
| Depreciation and amortization | 1,118 | 1,062 |
| Net amortization of premiums and (discounts) on investment securities and subordinated debentures | 5,631 | 6,229 |
| Share-based compensation | 231 | 53 |
| Change in accrued interest receivable and other assets, net | 3,594 | 154 |
| Gain on sale of other real estate | (4) | - |
| Gain on sale of bank premises and equipment | (12) | (58) |
| Net realized gain on sales of investment securities | (729) | (1,732) |
| Increase in deferred taxes | (271) | (159) |
| Change in other liabilities, net | (819) | 161 |
| Funding of loans held for sale, mortgage banking | (753,253) | (742,961) |
| Proceeds from sales of loans held for sale, mortgage banking | 740,799 | 746,218 |
| Fair value adjustment for loans held for sale, mortgage banking | (704) | 165 |
| Fair value adjustment on mortgage banking derivatives | (2,115) | (362) |
| Proceeds from sales of loans | 1,532 | 6,243 |
| Gains on sales of loans, net | (233) | (705) |
| Net cash provided by operating activities | 1,291 | 21,298 |
| INVESTING ACTIVITIES: | | |
| Purchases of investment securities | (91,847) | (155,577) |
| Proceeds from sales of investment securities | 75,973 | 126,536 |
| Proceeds from maturities of investment securities | 23,516 | 37,361 |
| Purchases of Federal Reserve and Federal Home Loan Bank Stock | (17,430) | (6,136) |
| Sales of Federal Reserve and Federal Home Loan Bank Stock | 15,438 | 6,026 |
| Net (increase) decrease in loans held for investment | (35,274) | 11,961 |
| Proceeds from sales of other real estate | 4 | - |
| Proceeds from sales of bank premises and equipment | 14 | 163 |
| Additions to bank premises and equipment | (2,600) | (1,651) |
| Net cash (used in) provided by investing activities | (32,206) | 18,683 |

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)

| | 2016 | 2015 |
|---|---|---|
| FINANCING ACTIVITIES: | | |
| Net decrease in deposits | $ (25,085) | $ (65,427) |
| Net increase (decrease) in short-term borrowings | 1,376 | (558) |
| Repayments of Federal Home Loan Bank advances | (429,950) | (152,350) |
| Proceeds from Federal Home Loan Bank advances | 480,650 | 152,350 |
| Dividends paid on preferred stock | - | (1,424) |
| Net cash provided by (used in) financing activities | 26,991 | (67,409) |
| NET DECREASE IN CASH AND CASH EQUIVALENTS | (3,924) | (27,428) |
| CASH AND CASH EQUIVALENTS, beginning of period | 15,189 | 41,124 |
| CASH AND CASH EQUIVALENTS, end of period | $ 11,265 | $ 13,696 |
| SUPPLEMENTAL CASH FLOW INFORMATION: | | |
| Interest paid | $ 2,297 | $ 1,855 |
| Income taxes paid | $ 2,211 | $ 3,331 |

See accompanying notes to consolidated financial statements.

# NOTE 1 – Organization of Operations, BNCCORP, INC.

BNCCORP, INC. (BNCCORP or BNC) is a registered bank holding company incorporated under the laws of Delaware. It is the parent company of BNC National Bank (the Bank or BNC Bank). BNCCORP operates community banking and wealth management businesses in North Dakota, Arizona, and Minnesota from 16 locations. BNC Bank also conducts mortgage banking from 17 locations in Arizona, Minnesota, North Dakota, Illinois, Kansas, Arkansas and Missouri.

The accounting and reporting policies of BNC 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 BNC 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, 2015. Accordingly, footnote disclosures which would substantially duplicate the disclosures contained in the December 31, 2015 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, 2015 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, 2016 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 significant accounting policies are unchanged since December 31, 2015.

## 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*, requires 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 was 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 adoption of this ASU did not have a material impact on the Company's consolidated financial statements.

ASU No. 2014-09, *Revenue from Contracts with Customers (Topic 606),* which will require 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, 2018 and interim periods within annual periods beginning after December 15, 2018. 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 was effective for annual reporting periods beginning after December 15, 2014. The adoption of this ASU did not have a material impact on the Company's consolidated financial statements.

ASU No. 2015-03, *Interest – Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs* was issued to clarify that debt issuance costs are to be presented in the balance sheet as a direct reduction from the carrying value of the related debt liability. ASU 2015-03 is effective for entities, other than public entities, for annual reporting periods beginning after December 15, 2015, and interim periods within fiscal years beginning after December 15, 2016. Early adoption of the amendment is permitted. The adoption of this ASU is not expected to have a material impact on the Company's consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*. This ASU requires lessees to recognize a lease liability and a right-to-use asset for all leases, including operating leases, with a term greater than twelve months on its balance sheet. Impact on the income statement will generally be through amortization of a right of use asset and recognition of expense for lease payments. This ASU is effective in annual and interim periods in fiscal years beginning after December 15, 2018, with early adoption permitted, and requires a modified retrospective transition method. We are currently in the process of evaluating the impact that this new guidance will have on our consolidated financial statements and related disclosures.

ASU No. 2016-13, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Statements* was issued to improve financial reporting about expected credit losses on loans and other financial assets held by banks, financial institutions and other organizations. The new standard will require financial institutions to forecast future conditions considering expected credit losses on the life of the asset and record a provision for credit losses at the origination of the asset. ASU 2016-13 is effective for public entities, who are non-SEC filers, for fiscal years beginning after December 15, 2020, including interim periods within those fiscal years. We are currently in the process of evaluating the impact that this new guidance will have on our consolidated financial statements and related disclosures.

## NOTE 3 – 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, 2016 or December 31, 2015. The carrying amount of available-for-sale securities and their approximate fair values were as follows (in thousands):

| | As of September 30, 2016 | | | |
|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| U.S. Treasury securities | $ 24,964 | $ 643 | $ - | $ 25,607 |
| U.S. government agency mortgage-backed securities guaranteed by GNMA | 60,123 | 1,172 | (137) | 61,158 |
| U.S. government agency small business administration pools guaranteed by SBA | 109,888 | 184 | (765) | 109,307 |
| Collateralized mortgage obligations guaranteed by GNMA/VA | 96,399 | 1,517 | (827) | 97,089 |
| Collateralized mortgage obligations issued by FNMA or FHLMC | 24,192 | 344 | (360) | 24,176 |
| State and municipal bonds | 84,391 | 8,008 | (17) | 92,382 |
| | $ 399,957 | $ 11,868 | $ (2,106) | $ 409,719 |

| | As of December 31, 2015 | | | |
|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| U.S. Treasury securities | $ 32,925 | $ 9 | $ (285) | $ 32,649 |
| U.S. government agency mortgage-backed securities guaranteed by GNMA | 105,407 | 46 | (1,022) | 104,431 |
| U.S. government agency small business administration pools guaranteed by SBA | 105,150 | 737 | (209) | 105,678 |
| Collateralized mortgage obligations guaranteed by GNMA/VA | 61,418 | 678 | (203) | 61,893 |
| Collateralized mortgage obligations issued by FNMA or FHLMC | 21,607 | 206 | (151) | 21,662 |
| State and municipal bonds | 87,779 | 5,413 | (159) | 93,033 |
| | $ 414,286 | $ 7,089 | $ (2,029) | $ 419,346 |

The amortized cost and estimated fair market value of available-for-sale securities classified according to their contractual maturities at September 30, 2016 were as follows (in thousands):

| | Amortized Cost | Estimated Fair Value |
|---|---|---|
| Due in one year or less | $ - | $ - |
| Due after one year through five years | 13,612 | 14,164 |
| Due after five years through ten years | 30,928 | 32,090 |
| Due after ten years | 355,417 | 363,465 |
| Total | $ 399,957 | $ 409,719 |

This disclosure is required pursuant to Generally Accepted Accounting Principles. This table is not intended to reflect actual maturities, cash flows, or interest rate risk.

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, 2016 | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Less than 12 months | | | 12 months or more | | | Total | | |
| Description of Securities | # | 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 | 3 | 17,455 | (137) | - | - | - | 3 | 17,455 | (137) |
| U.S. government agency small business administration pools guaranteed by SBA | 15 | 66,487 | (487) | 7 | 13,932 | (278) | 22 | 80,419 | (765) |
| Collateralized mortgage obligations guaranteed by GNMA/VA | 6 | 53,877 | (827) | - | - | - | 6 | 53,877 | (827) |
| Collateralized mortgage obligations issued by FNMA or FHLMC | 3 | 11,021 | (344) | 2 | 2,905 | (16) | 5 | 13,926 | (360) |
| State and municipal bonds | 2 | 2,274 | (17) | - | - | - | 2 | 2,274 | (17) |
| Total temporarily impaired securities | 29 | $ 151,114 | $ (1,812) | 9 | $ 16,837 | $ (294) | 38 | $ 167,951 | $ (2,106) |

| | December 31, 2015 | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Less than 12 months | | | 12 months or more | | | Total | | |
| Description of Securities | # | Fair Value | Unrealized Loss | # | Fair Value | Unrealized Loss | # | Fair Value | Unrealized Loss |
| U.S. Treasury securities | 2 | $ 24,673 | $ (285) | - | $ - | $ - | 2 | $ 24,673 | $ (285) |
| U.S. government agency mortgage-backed securities guaranteed by GNMA | 15 | 99,357 | (1,022) | - | - | - | 15 | 99,357 | (1,022) |
| U.S. government agency small business administration pools guaranteed by SBA | 9 | 32,910 | (138) | 3 | 4,691 | (71) | 12 | 37,601 | (209) |
| Collateralized mortgage obligations guaranteed by GNMA/VA | 7 | 21,299 | (203) | - | - | - | 7 | 21,299 | (203) |
| Collateralized mortgage obligations issued by FNMA or FHLMC | 1 | 4,854 | (74) | 2 | 3,577 | (77) | 3 | 8,431 | (151) |
| State and municipal bonds | 2 | 8,147 | (159) | - | - | - | 2 | 8,147 | (159) |
| Total temporarily impaired securities | 36 | $ 191,240 | $ (1,881) | 5 | $ 8,268 | $ (148) | 41 | $ 199,508 | $ (2,029) |

Management regularly evaluates each security with unrealized losses to determine whether losses are other-than-temporary. When determining whether a security is other-than-temporarily impaired, management assesses whether it has the intent to sell the security or whether it is more likely than not that it will be required to sell the security prior to its anticipated recovery. When evaluating a security, 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 of the security, and the collateral underlying the security.

There were no securities that management concluded were other-than-temporarily impaired at September 30, 2016 or December 31, 2015.

## NOTE 4 – Loans and Leases

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

| | September 30, 2016 | December 31, 2015 |
|---|---|---|
| Loans held for sale-mortgage banking | $ 63,614 | $ 50,445 |
| Commercial and industrial | $ 124,733 | $ 125,009 |
| Commercial real estate | 172,722 | 149,099 |
| SBA | 29,802 | 25,860 |
| Consumer | 57,708 | 47,073 |
| Land and land development | 15,776 | 17,627 |
| Construction | 12,228 | 15,187 |
| Gross loans and leases held for investment | 412,969 | 379,855 |
| Unearned income and net unamortized deferred fees and costs | 182 | 48 |
| Loans, net of unearned income and unamortized fees and costs | 413,151 | 379,903 |
| Allowance for credit losses | (8,684) | (8,611) |
| Net loans and leases held for investment | $ 404,467 | $ 371,292 |

## NOTE 5 – Allowance for Credit Losses

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

| | Three Months Ended September 30, 2016 | | | | | | |
|---|---|---|---|---|---|---|---|
| | Commercial and industrial | Commercial real estate | SBA | Consumer | Land and land development | Construction | Total |
| Balance, beginning of period | $ 3,343 | $ 2,483 | $ 1,557 | $ 634 | $ 577 | $ 131 | $ 8,725 |
| Provision (reduction) | (271) | 625 | (50) | 164 | (42) | (26) | 400 |
| Loans charged off | (438) | - | (2) | (13) | - | - | (453) |
| Loan recoveries | - | 5 | 1 | 6 | - | - | 12 |
| Balance, end of period | $ 2,634 | $ 3,113 | $ 1,506 | $ 791 | $ 535 | $ 105 | $ 8,684 |

| | Three Months Ended September 30, 2015 | | | | | | |
|---|---|---|---|---|---|---|---|
| | Commercial and industrial | Commercial real estate | SBA | Consumer | Land and land development | Construction | Total |
| Balance, beginning of period | $ 2,935 | $ 2,306 | $ 1,315 | $ 609 | $ 1,129 | $ 297 | $ 8,591 |
| Provision (reduction) | 882 | (879) | (343) | 10 | (18) | (52) | (400) |
| Loans charged off | - | - | (25) | (10) | - | - | (35) |
| Loan recoveries | 7 | 428 | 2 | 6 | - | - | 443 |
| Balance, end of period | $ 3,824 | $ 1,855 | $ 949 | $ 615 | $ 1,111 | $ 245 | $ 8,599 |

| | Nine Months Ended September 30, 2016 | | | | | | |
|---|---|---|---|---|---|---|---|
| | Commercial and industrial | Commercial real estate | SBA | Consumer | Land and land development | Construction | Total |
| Balance, beginning of period | $ 3,205 | $ 1,999 | $ 1,578 | $ 640 | $ 1,041 | $ 148 | $ 8,611 |
| Provision (reduction) | 66 | 1,104 | (16) | 195 | (506) | (43) | 800 |
| Loans charged off | (637) | - | (71) | (58) | - | - | (766) |
| Loan recoveries | - | 10 | 15 | 14 | - | - | 39 |
| Balance, end of period | $ 2,634 | $ 3,113 | $ 1,506 | $ 791 | $ 535 | $ 105 | $ 8,684 |

| | Nine Months Ended September 30, 2015 | | | | | | |
|---|---|---|---|---|---|---|---|
| | Commercial and industrial | Commercial real estate | SBA | Consumer | Land and land development | Construction | Total |
| Balance, beginning of period | $ 2,686 | $ 2,496 | $ 1,190 | $ 516 | $ 1,436 | $ 277 | $ 8,601 |
| Provision (reduction) | 1,178 | (1,187) | (156) | 122 | (325) | (32) | (400) |
| Loans charged off | (47) | - | (145) | (38) | - | - | (230) |
| Loan recoveries | 7 | 546 | 60 | 15 | - | - | 628 |
| Balance, end of period | $ 3,824 | $ 1,855 | $ 949 | $ 615 | $ 1,111 | $ 245 | $ 8,599 |

The following table shows the balance in the allowance for credit losses at September 30, 2016, and December 31, 2015, and the related loan balances, segregated on the basis of impairment methodology (in thousands). Impaired loans are loans on nonaccrual status and troubled debt restructurings, which are individually evaluated for impairment, and other loans deemed to have similar risk characteristics. All other loans are collectively evaluated for impairment.

| | Allowance For Credit Losses | | | Gross Loans and Leases Held for Investment | | |
|---|---|---|---|---|---|---|
| | Impaired | Other | Total | Impaired | Other | Total |
| **September 30, 2016** | | | | | | |
| Commercial and industrial | $ 330 | $ 2,304 | $ 2,634 | $ 1,542 | $ 123,191 | $ 124,733 |
| Commercial real estate | 299 | 2,814 | 3,113 | 1,561 | 171,161 | 172,722 |
| SBA | 311 | 1,195 | 1,506 | 311 | 29,491 | 29,802 |
| Consumer | 15 | 776 | 791 | 353 | 57,355 | 57,708 |
| Land and land development | - | 535 | 535 | - | 15,776 | 15,776 |
| Construction | - | 105 | 105 | - | 12,228 | 12,228 |
| Total | $ 955 | $ 7,729 | $ 8,684 | $ 3,767 | $ 409,202 | $ 412,969 |
| **December 31, 2015** | | | | | | |
| Commercial and industrial | $ - | $ 3,205 | $ 3,205 | $ - | $ 125,009 | $ 125,009 |
| Commercial real estate | - | 1,999 | 1,999 | 1,578 | 147,521 | 149,099 |
| SBA | 313 | 1,265 | 1,578 | 313 | 25,547 | 25,860 |
| Consumer | 33 | 607 | 640 | 383 | 46,690 | 47,073 |
| Land and land development | - | 1,041 | 1,041 | - | 17,627 | 17,627 |
| Construction | - | 148 | 148 | - | 15,187 | 15,187 |
| Total | $ 346 | $ 8,265 | $ 8,611 | $ 2,274 | $ 377,581 | $ 379,855 |

## 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, 2016 | | | | | |
|---|---|---|---|---|---|---|
| | Current | 31-89 Days Past Due | 90 Days or More Past Due And Accruing | Total Performing | Non-accrual | Total |
| Commercial and industrial: | | | | | | |
| Business loans | $ 51,942 | $ 333 | $ - | $ 52,275 | $ 1,542 | $ 53,817 |
| Agriculture | 20,547 | - | - | 20,547 | - | 20,547 |
| Owner-occupied commercial real estate | 50,369 | - | - | 50,369 | - | 50,369 |
| Commercial real estate | 172,722 | - | - | 172,722 | - | 172,722 |
| SBA | 29,491 | - | - | 29,491 | 311 | 29,802 |
| Consumer: | | | | | | |
| Automobile | 6,774 | 18 | - | 6,792 | 53 | 6,845 |
| Home equity | 7,580 | - | - | 7,580 | - | 7,580 |
| 1st mortgage | 13,272 | - | - | 13,272 | - | 13,272 |
| Other | 29,961 | 49 | 1 | 30,011 | - | 30,011 |
| Land and land development | 15,776 | - | - | 15,776 | - | 15,776 |
| Construction | 12,228 | - | - | 12,228 | - | 12,228 |
| Total loans held for investment | 410,662 | 400 | 1 | 411,063 | 1,906 | 412,969 |
| Loans held for sale | 63,613 | - | 1 | 63,614 | | 63,614 |
| Total gross loans | $ 474,275 | $ 400 | $ 2 | $ 474,677 | $ 1,906 | $ 476,583 |

| | December 31, 2015 | | | | | |
|---|---|---|---|---|---|---|
| | Current | 31-89 Days Past Due | 90 Days or More Past Due And Accruing | Total Performing | Non-accrual | Total |
| Commercial and industrial: | | | | | | |
| Business loans | $ 62,563 | $ 377 | $ - | $ 62,940 | $ - | $ 62,940 |
| Agriculture | 18,003 | - | - | 18,003 | - | 18,003 |
| Owner-occupied commercial real estate | 44,066 | - | - | 44,066 | - | 44,066 |
| Commercial real estate | 149,099 | - | - | 149,099 | - | 149,099 |
| SBA | 24,632 | 915 | - | 25,547 | 313 | 25,860 |
| Consumer: | | | | | | |
| Automobile | 6,057 | 69 | - | 6,126 | 51 | 6,177 |
| Home equity | 8,134 | - | - | 8,134 | - | 8,134 |
| 1st mortgage | 12,161 | - | - | 12,161 | - | 12,161 |
| Other | 20,564 | 11 | - | 20,575 | 26 | 20,601 |
| Land and land development | 17,452 | - | 175 | 17,627 | - | 17,627 |
| Construction | 15,187 | - | - | 15,187 | - | 15,187 |
| Total loans held for investment | 377,918 | 1,372 | 175 | 379,465 | 390 | 379,855 |
| Loans held for sale | 50,444 | 1 | - | 50,445 | - | 50,445 |
| Total gross loans | $ 428,362 | $ 1,373 | $ 175 | $ 429,910 | $ 390 | $ 430,300 |

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):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| Interest income that would have been recorded | $ 33 | $ 4 | $ 56 | $ 9 |
| Interest income recorded | - | - | - | - |
| Effect on interest income | $ 33 | $ 4 | $ 56 | $ 9 |

**Credit Risk by Internally Assigned Grade**

The Company maintains an internal risk rating process in order to increase the precision and effectiveness of credit risk management. Internal grade is generally categorized into the following four categories: pass, watch list, substandard, and doubtful.

At September 30, 2016, the Company had $391.9 million of loans categorized as pass rated loans compared to $362.1 million at December 31, 2015.

Loans designated as watch list are loans that possess some credit deficiency that deserves close attention due to emerging problems. Such loans pose unwarranted financial risk that, if left uncorrected, may result in deterioration of the repayment prospects for the asset or in the Bank's credit position at some future date. At September 30, 2016, the Company had $10.9 million of loans categorized as watch list loans compared to $7.9 million at December 31, 2015.

Loans graded as substandard or doubtful are considered "Classified" loans for regulatory purposes. Loans classified as substandard are loans that are generally inadequately protected by the current net worth and paying capacity of the obligor, or by the collateral pledged, if any. Loans classified as substandard have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. Substandard loans are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. Loans classified as doubtful have the weaknesses of those classified as substandard, with additional characteristics that make collection in full on the basis of currently existing facts, conditions and values questionable, and there is a high possibility of loss. At September 30, 2016, the Company had $7.3 million of substandard loans and $1.9 million of doubtful loans. This compares to $9.4 million of substandard loans and $379 thousand of doubtful loans as of December 31, 2015.

**Impaired loans**

Impaired loans include loans on which 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, 2016 | | | | |
|---|---|---|---|---|---|
| | Unpaid Principal | Recorded Investment | Related Allowance | Average Recorded Balance | Interest Income Recognized (9 months) |
| Impaired loans with an allowance recorded: | | | | | |
| Commercial and industrial: | | | | | |
| Business loans | $ 1,980 | $ 1,542 | $ 330 | $ 1,892 | $ - |
| Agriculture | - | - | - | - | - |
| Owner-occupied commercial real estate | - | - | - | - | - |
| Commercial real estate | 1,859 | 1,561 | 299 | 1,574 | 60 |
| SBA | 337 | 311 | 311 | 319 | - |
| Consumer: | | | | | |
| Automobile | 30 | 29 | 15 | 34 | - |
| Home equity | - | - | - | - | - |
| 1st mortgage | - | - | - | - | - |
| Other | - | - | - | - | - |
| Land and land development | - | - | - | - | - |
| Construction | - | - | - | - | - |
| Loans held for sale | - | - | - | - | - |
| **Total impaired loans with an allowance recorded** | $ 4,206 | $ 3,443 | $ 955 | $ 3,819 | $ 60 |
| | | | | | |
| Impaired loans without an allowance recorded: | | | | | |
| Commercial and industrial: | | | | | |
| Business loans | $ - | $ - | $ - | $ - | $ - |
| Agriculture | - | - | - | - | - |
| Owner-occupied commercial real estate | - | - | - | - | - |
| Commercial real estate | - | - | - | - | - |
| SBA | - | - | - | - | - |
| Consumer: | | | | | |
| Automobile | 37 | 24 | - | 26 | - |
| Home equity | - | - | - | - | - |
| 1st mortgage | 1,878 | 300 | - | 302 | 9 |
| Other | - | - | - | - | - |
| Land and land development | - | - | - | - | - |
| Construction | - | - | - | - | - |
| Loans held for sale | - | - | - | - | - |
| **Total impaired loans without an allowance recorded** | $ 1,915 | $ 324 | $ - | $ 328 | $ 9 |
| **TOTAL IMPAIRED LOANS** | $ 6,121 | $ 3,767 | $ 955 | $ 4,147 | $ 69 |

| | December 31, 2015 | | | | |
|---|---|---|---|---|---|
| | **Unpaid Principal** | **Recorded Investment** | **Related Allowance** | **Average Recorded Balance** | **Interest Income Recognized (12 months)** |
| Impaired loans with an allowance recorded: | | | | | |
| Commercial and industrial: | | | | | |
| Business loans | $ - | $ - | $ - | $ - | $ - |
| Agriculture | - | - | - | - | - |
| Owner-occupied commercial real estate | - | - | - | - | - |
| Commercial real estate | - | - | - | - | - |
| SBA | 325 | 313 | 313 | 324 | - |
| Consumer: | | | | | |
| Automobile | 39 | 39 | 20 | 40 | - |
| Home equity | - | - | - | - | - |
| 1st mortgage | - | - | - | - | - |
| Other | 26 | 26 | 13 | 26 | - |
| Land and land development | - | - | - | - | - |
| Construction | - | - | - | - | - |
| Loans held for sale | - | - | - | - | - |
| **Total impaired loans with an allowance recorded** | $ 390 | $ 378 | $ 346 | $ 390 | $ - |
| Impaired loans without an allowance recorded: | | | | | |
| Commercial and industrial: | | | | | |
| Business loans | $ - | $ - | $ - | $ - | $ - |
| Agriculture | - | - | - | - | - |
| Owner-occupied commercial real estate | - | - | - | - | - |
| Commercial real estate | 1,876 | 1,578 | - | 1,579 | 80 |
| SBA | - | - | - | - | - |
| Consumer: | | | | | |
| Automobile | 29 | 12 | - | 15 | - |
| Home equity | - | - | - | - | - |
| 1st mortgage | 1,878 | 306 | - | 308 | 13 |
| Other | - | - | - | - | - |
| Land and land development | - | - | - | - | - |
| Construction | - | - | - | - | - |
| Loans held for sale | - | - | - | - | - |
| **Total impaired loans without an allowance recorded** | $ 3,783 | $ 1,896 | $ - | $ 1,902 | $ 93 |
| **TOTAL IMPAIRED LOANS** | $ 4,173 | $ 2,274 | $ 346 | $ 2,292 | $ 93 |

**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 that we would not otherwise consider, compared to the original terms and conditions of the loan, the modified loan is considered a troubled debt restructuring.

The Company follows 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, 2016 | | | |
|---|---|---|---|---|
| | Accrual | Non-accrual | Total | Allowance |
| Commercial and industrial: | | | | |
| Business loans | $ - | $ - | $ - | $ - |
| Agriculture | - | - | - | - |
| Owner-occupied commercial real estate | - | - | - | - |
| Commercial real estate | 1,561 | - | 1,561 | 299 |
| SBA | - | 193 | 193 | 193 |
| Consumer: | | | | |
| Automobile | - | - | - | - |
| Home equity | - | - | - | - |
| 1st mortgage | 300 | - | 300 | - |
| Other | - | - | - | - |
| Land and land development | - | - | - | - |
| Construction | - | - | - | - |
| Loans held for sale | - | - | - | - |
| | $ 1,861 | $ 193 | $ 2,054 | $ 492 |

| | December 31, 2015 | | | |
|---|---|---|---|---|
| | Accrual | Non-accrual | Total | Allowance |
| Commercial and industrial: | | | | |
| Business loans | $ - | $ - | $ - | $ - |
| Agriculture | - | - | - | - |
| Owner-occupied commercial real estate | - | - | - | - |
| Commercial real estate | 1,578 | - | 1,578 | - |
| SBA | - | 313 | 313 | 313 |
| Consumer: | | | | |
| Automobile | - | - | - | - |
| Home equity | - | - | - | - |
| 1st mortgage | 306 | - | 306 | - |
| Other | - | - | - | - |
| Land and land development | - | - | - | - |
| Construction | - | - | - | - |
| Loans held for sale | - | - | - | - |
| | $ 1,884 | $ 313 | $ 2,197 | $ 313 |

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

When a loan is modified as a TDR, there may be a direct, material impact on the loans within the Balance Sheet, as principal balances may be partially forgiven. There were no new TDRs for the three or nine month period ending September 30, 2016. There was one new TDR for the three month period ending September 30, 2015. The pre-modification and post-modification balance of the new TDR equated to $71 thousand. For the nine month period ending September 30, 2015, there were three new TDRs with a pre-modification and post-modification balance of $329 thousand.

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,** | |
|---|---|---|---|---|
| | **2016** | **2015** | **2016** | **2015** |
| Interest income that would have been recorded | $ 56 | $ 57 | $ 167 | $ 165 |
| Interest income recorded | 23 | 23 | 69 | 70 |
| Effect on interest income | $ 33 | $ 34 | $ 98 | $ 95 |

There were no additional funds committed to borrowers who are in TDR status at September 30, 2016 and December 31, 2015.

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, 2016 and September 30, 2015 and defaulted during the three and nine months ended September 30, 2016 and September 30, 2015.

# NOTE 6 – 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):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| **Balance, beginning of period** | $ 225 | $ 242 | $ 242 | $ 256 |
| Transfers from nonperforming loans | - | - | - | - |
| Transfers from premises and equipment | - | - | - | - |
| Real estate sold | - | - | (4) | - |
| Net gains on sale of assets | - | - | 4 | - |
| Provision | - | - | (17) | (14) |
| **Balance, end of period** | $ 225 | $ 242 | $ 225 | $ 242 |

| | September 30, 2016 | December 31, 2015 | September 30, 2015 |
|---|---|---|---|
| Other real estate | $ 954 | $ 954 | $ 954 |
| Valuation allowance | (729) | (712) | (712) |
| Other real estate, net | $ 225 | $ 242 | $ 242 |

## NOTE 7 – Earnings Per Share

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

| | Three Months Ended September 30, 2016 | Nine Months Ended September 30, 2016 |
|---|---|---|
| Denominator for basic earnings per share: | | |
| Average common shares outstanding | 3,453,949 | 3,445,500 |
| Dilutive effect of stock compensation | 75,330 | 74,911 |
| Denominator for diluted earnings per share | 3,529,279 | 3,520,411 |
| Numerator (in thousands): | | |
| Net income | $ 2,259 | $ 5,709 |
| Preferred stock costs | - | - |
| Net income available to common shareholders | $ 2,259 | $ 5,709 |
| Basic earnings per common share | $ 0.65 | $ 1.66 |
| Diluted earnings per common share | $ 0.64 | $ 1.62 |

| | Three Months Ended September 30, 2015 | Nine Months Ended September 30, 2015 |
|---|---|---|
| Denominator for basic earnings per share: | | |
| Average common shares outstanding | 3,388,706 | 3,384,634 |
| Dilutive effect of stock compensation | 112,616 | 113,028 |
| Denominator for diluted earnings per share | 3,501,322 | 3,497,662 |
| Numerator (in thousands): | | |
| Net income | $ 1,875 | $ 7,376 |
| Preferred stock costs | 475 | 1,424 |
| Net income available to common shareholders | $ 1,400 | $ 5,952 |
| Basic earnings per common share | $ 0.41 | $ 1.76 |
| Diluted earnings per common share | $ 0.40 | $ 1.70 |

## NOTE 8 – 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 three share-based plans for certain key employees and directors whereby shares of common stock have been reserved for awards in the form of stock options or restricted stock awards. The plans are as follows:

| | 1995 | 2002 | 2010 | Total |
|---|---|---|---|---|
| Total Shares in Plan | 250,000 | 125,000 | 250,000 | 625,000 |
| Total Shares Available for Issuance | 48,751 | - | 250,000 | 298,751 |

Following is a summary of fully vested stock options and options expected to vest as of September 30, 2016:

| | Stock Options Outstanding | Stock Options Currently Exercisable | Stock Options Vested and Expected to Vest |
|---|---|---|---|
| Number | 75,600 | 75,600 | 75,600 |
| Weighted-average exercise price | $3.00 | $3.00 | $3.00 |
| Weighted-average remaining contractual term | 3.45 years | 3.45 years | 3.45 years |

The stock options currently outstanding can be exercised until they expire on March 17, 2020.

The Company recognized share-based compensation expense of $25,000 related to restricted stock for the three month period ended September 30, 2016, and $84,000 for the nine month period ended September 30, 2016. The Company recognized share-based compensation expense of $34,000 related to restricted stock for the three month period ended September 30, 2015, and $102,000 for the nine month period ended September 30, 2015.

At September 30, 2016, the Company had $27,000 of unamortized restricted stock compensation expense. All of this expense will be amortized by December 31, 2017. The cost of restricted stock granted is recognized over the vesting period, which is generally three or more years.

## NOTE 9 – 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.

For the periods presented, Treasury Securities were considered to be Level 1 while all other assets and liabilities valued at fair value were considered to be Level 2. There were no transfers into or out of the respective levels during the period.

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, 2016 | | | | Nine Months Ended September 30, 2016 |
|---|---|---|---|---|---|
| | **Total** | **Level 1** | **Level 2** | **Level 3** | **Total gains/(losses)** |
| **ASSETS** | | | | | |
| Securities available for sale | $ 409,719 | $ 25,607 | $ 384,112 | $ - | $ 729 |
| Loans held for sale | 63,614 | - | 63,614 | - | 704 |
| Commitments to originate mortgage loans | 5,497 | - | 5,497 | - | 2,938 |
| Total assets at fair value | $ 478,830 | $ 25,607 | $ 453,223 | $ - | $ 4,371 |
| | | | | | |
| **LIABILITIES** | | | | | |
| Commitments to sell mortgage loans | $ 682 | $ - | $ 682 | $ - | $ (599) |
| Mortgage banking short positions | 247 | - | 247 | - | (224) |
| Total liabilities at fair value | $ 929 | $ - | $ 929 | $ - | $ (823) |

| | Carrying Value at December 31, 2015 | | | | Twelve Months Ended December 31, 2015 |
|---|---|---|---|---|---|
| | **Total** | **Level 1** | **Level 2** | **Level 3** | **Total gains/(losses)** |
| **ASSETS** | | | | | |
| Securities available for sale | $ 419,346 | $ 32,649 | $ 386,697 | $ - | $ 1,655 |
| Loans held for sale | 50,445 | - | 50,445 | - | (151) |
| Commitments to originate mortgage loans | 1,859 | - | 1,859 | - | (185) |
| Total assets at fair value | $ 471,650 | $ 32,649 | $ 439,001 | $ - | $ 1,319 |
| | | | | | |
| **LIABILITIES** | | | | | |
| Commitments to sell mortgage loans | $ 83 | $ - | $ 83 | $ - | $ 162 |
| Mortgage banking short positions | 23 | - | 23 | - | 212 |
| Total liabilities at fair value | $ 106 | $ - | $ 106 | $ - | $ 374 |

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, 2016** | | | | | | | | **Nine Months Ended September 30, 2016** | |
|---|---|---|---|---|---|---|---|---|---|---|
| | **Total** | | **Level 1** | | **Level 2** | | **Level 3** | | **Total gains/(losses)** | |
| Impaired loans[1] | $ | 2,812 | $ | - | $ | 2,812 | $ | - | $ | (1,100) |
| Other real estate[2] | | 225 | | - | | 225 | | - | | (13) |
| Total | $ | 3,037 | $ | - | $ | 3,037 | $ | - | $ | (1,113) |

| | **Carrying Value at December 31, 2015** | | | | | | | | **Twelve Months Ended December 31, 2015** | |
|---|---|---|---|---|---|---|---|---|---|---|
| | **Total** | | **Level 1** | | **Level 2** | | **Level 3** | | **Total gains/(losses)** | |
| Impaired loans[1] | $ | 1,928 | $ | - | $ | 1,928 | $ | - | $ | 192 |
| Other real estate[2] | | 242 | | - | | 242 | | - | | (7) |
| Total | $ | 2,170 | $ | - | $ | 2,170 | $ | - | $ | 185 |

(1) The carrying value represents the book value less allocated reserves based on the appraised value of the collateral. The gain or loss reported is the change in the reserve balances allocated on individual impaired loans in addition to the actual write-downs for the period presented.
(2) The carrying value represents the fair value of the collateral less estimated selling costs and is based upon appraised values. The gain or loss reported is a combination of gains and/or losses on sales of other real estate and provisions for other real estate losses.

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 10 – 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, 2016 | | December 31, 2015 | |
|---|---|---|---|---|---|
| | | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| Assets: | | | | | |
| Cash and cash equivalents | Level 1 | $ 11,265 | $ 11,265 | $ 15,189 | $ 15,189 |
| Investment securities available for sale | Level 1 | 25,607 | 25,607 | 32,649 | 32,649 |
| Investment securities available for sale | Level 2 | 384,112 | 384,112 | 386,697 | 386,697 |
| Federal Reserve Bank and Federal Home Loan Bank stock | Level 2 | 5,211 | 5,211 | 3,219 | 3,219 |
| Loans held for sale-mortgage banking | Level 2 | 63,614 | 63,614 | 50,445 | 50,445 |
| Commitments to originate mortgage loans | Level 2 | 5,497 | 5,497 | 1,859 | 1,859 |
| Loans and leases held for investment, net | Level 2 | 404,467 | 403,878 | 371,292 | 370,243 |
| Accrued interest receivable | Level 2 | 3,677 | 3,677 | 4,027 | 4,027 |
| | | $ 903,450 | $ 902,861 | $ 865,377 | $ 864,328 |
| Liabilities and Stockholders' Equity: | | | | | |
| Deposits, noninterest-bearing | Level 2 | $ 150,051 | $ 150,051 | $ 168,259 | $ 168,259 |
| Deposits, interest-bearing | Level 2 | 605,313 | 604,921 | 612,190 | 612,449 |
| Borrowings and advances | Level 2 | 83,227 | 83,877 | 31,151 | 31,204 |
| Accrued interest payable | Level 2 | 729 | 729 | 487 | 487 |
| Accrued expenses | Level 2 | 8,265 | 8,265 | 7,398 | 7,398 |
| Commitments to sell mortgage loans | Level 2 | 682 | 682 | 83 | 83 |
| Mortgage banking short positions | Level 2 | 247 | 247 | 23 | 23 |
| Guaranteed preferred beneficial interests in Company's subordinated debentures | Level 2 | 15,014 | 9,127 | 15,015 | 9,426 |
| | | $ 863,528 | $ 857,899 | $ 834,606 | $ 829,329 |
| Financial instruments with off-balance-sheet risk: | | | | | |
| Commitments to extend credit | Level 2 | $ - | $ 208 | $ - | $ 203 |
| Standby and commercial letters of credit | Level 2 | $ - | $ 9 | $ - | $ 13 |

## NOTE 11. Federal Home Loan Bank Advances

As of September 30, 2016, the Bank had $58.0 million of FHLB advances outstanding. At September 30, 2016, BNC Bank had mortgage loans with unamortized principal balances of approximately $146.9 million and investment securities with carrying value of approximately $55.9 million pledged as collateral to the FHLB. The Bank had the ability to draw advances up to approximately $97.8 million based upon its current pool of pledged collateral, subject to a requirement to purchase additional FHLB stock.

As of December 31, 2015, the Bank had $7.3 million of FHLB advances outstanding. At December 31, 2015, the Bank had mortgage loans pledged as collateral to the FHLB with unamortized principal balances of approximately $127.4 million. The Bank had the ability to draw advances up to approximately $77.6 million based upon the mortgage loans that are currently pledged, subject to a requirement to purchase additional FHLB stock.

## NOTE 12. Long-Term Borrowings

The following table sets forth selected information for long-term borrowings (borrowings with an original maturity of greater than one year) (in thousands):

| | September 30, 2016 | December 31, 2015 |
|---|---|---|
| Note payable, interest due quarterly beginning on April 1, 2016 and ending October 19, 2025, interest payable at a fixed rate of 6.35% | $ 10,000 | $ 10,000 |

On October 19, 2015, the Company entered into a $10.0 million term loan agreement with another bank. The long term borrowing is subordinated debt that qualifies as Tier 2 capital for the Company. The loan agreement includes various covenants that are primarily operational rather than financial in nature. As of September 30, 2016, the Company was in compliance with these covenants. The note may be repaid by the Company at par in whole or in part beginning October 19, 2020.

## NOTE 13 – Other Borrowings

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

**September 30, 2016**

| **Unsecured Borrowing Lines:** | | **Line** | **Outstanding** | **Available** |
|---|---|---|---|---|
| BNC National Bank Lines (1) | | $ 34,500 | $ - | $ 34,500 |

| **Secured Borrowing Lines:** | **Collateral Pledged** | **Line** | **Outstanding** | **Available** |
|---|---|---|---|---|
| BNC National Bank Line | $ 598 | $ 418 | $ - | $ 418 |
| BNC Line | 97,482 | 10,000 | - | 10,000 |
| Total | $ 98,080 | $ 10,418 | $ - | $ 10,418 |

(1) The unsecured BNC National Bank Lines consists of three separate lines with three institutions in individual amounts of $12.5 million, $10 million, and $12 million.

At September 30, 2016, the pledged collateral for the BNC Bank line was comprised of one mortgage loan and the pledged collateral for the BNC line is the common stock of BNC Bank.

**December 31, 2015**

| **Unsecured Borrowing Lines:** | | **Line** | **Outstanding** | **Available** |
|---|---|---|---|---|
| BNC National Bank Lines (1) | | $ 34,500 | $ - | $ 34,500 |

| **Secured Borrowing Lines:** | **Collateral Pledged** | **Line** | **Outstanding** | **Available** |
|---|---|---|---|---|
| BNC National Bank Line | $ 650 | $ 387 | $ - | $ 387 |
| BNC Line | 87,862 | 10,000 | - | 10,000 |
| Total | $ 88,512 | $ 10,387 | $ - | $ 10,387 |

(1) The unsecured BNC National Bank Lines consists of three separate lines with three institutions in individual amounts of $12.5 million, $10 million, and $12 million.

At December 31, 2015, the pledged collateral for the BNC Bank line was comprised of collateralized mortgage obligations and the pledged collateral for the BNC line is the common stock of BNC Bank.

## NOTE 14 – Guaranteed Preferred Beneficial Interest's in Company's Subordinated Debentures

In July 2007, BNC 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, 2016 and December 31, 2015 was 2.05% and 1.73%, 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 Federal Reserve Board.

## NOTE 15 – Stockholders' Equity

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

During 2015, the Company, after receiving approval from its regulator, redeemed the Series A and Series B preferred stock. The redemption price for these shares of preferred stock was the stated liquidation preference amount of $1,000 per share or an aggregate $21,098,000.

Prior to the redemption, the Series A preferred stock (20,093 shares) accrued and paid dividends at 5% per annum until February 2014 and 9% per annum thereafter. Series B preferred stock (1,005 shares) accrued and paid dividends at 9% per annum.

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

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

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

## NOTE 16 – Regulatory Capital and Current Operating Environment

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

At September 30, 2016, our capital ratios exceeded all regulatory capital thresholds and maintained sufficient capital conservation buffers to avoid limitations on certain types of capital distributions.

At September 30, 2016 and December 31, 2015 our regulatory capital amounts and ratios were as follows (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, 2016** | | | | | | | | |
| **Total Risk Based Capital**: | | | | | | | | |
| Consolidated | $ 102,348 | 19.24 % | $ 42,560 | ≥8.0 % | $ N/A | N/A % | $ N/A | N/A% |
| BNC National Bank | 96,525 | 18.16 | 42,529 | ≥8.0 | 53,200 | 10.0 | 43,325 | 8.16 |
| **Tier 1 Risk Based Capital**: | | | | | | | | |
| Consolidated | 85,673 | 16.10 | 31,920 | ≥6.0 | N/A | N/A | N/A | N/A |
| BNC National Bank | 89,854 | 16.90 | 31,897 | ≥6.0 | 42,529 | 8.0 | 47,325 | 8.90 |
| **Common Equity Tier 1 Risk Based Capital:** | | | | | | | | |
| Consolidated | 70,659 | 13.28 | 23,940 | ≥4.5 | N/A | N/A | N/A | N/A |
| BNC National Bank | 89,854 | 16.90 | 23,923 | ≥4.5 | 34,555 | 6.5 | 55,299 | 10.40 |
| **Tier 1 Leverage Capital**: | | | | | | | | |
| Consolidated | 85,673 | 9.30 | 36,861 | ≥4.0 | N/A | N/A | N/A | N/A |
| BNC National Bank | 89,854 | 9.76 | 36,832 | ≥4.0 | 46,040 | 5.0 | 43,814 | 4.76 |
| **Tangible Common Equity** (to total assets): | | | | | | | | |
| Consolidated | 77,676 | 8.24 | N/A | N/A | N/A | N/A | N/A | N/A |
| BNC National Bank | 97,316 | 10.33 | N/A | N/A | N/A | N/A | N/A | N/A |
| | | | | | | | | |
| **December 31, 2015** | | | | | | | | |
| **Total Risk Based Capital**: | | | | | | | | |
| Consolidated | $ 95,770 | 20.07 % | $ 38,172 | ≥8.00 % | $ N/A | N/A % | $ N/A | N/A% |
| BNC National Bank | 89,178 | 18.71 | 38,130 | ≥8.00 | 47,662 | 10.00 | 41,516 | 8.71 |
| **Tier 1 Risk Based Capital**: | | | | | | | | |
| Consolidated | 79,773 | 16.72 | 28,629 | ≥6.00 | N/A | N/A | N/A | N/A |
| BNC National Bank | 83,187 | 17.45 | 28,597 | ≥6.00 | 38,130 | 8.00 | 45,057 | 9.45 |
| **Common Equity Tier 1 Risk Based Capital:** | | | | | | | | |
| Consolidated | 64,758 | 13.57 | 21,472 | ≥4.50 | N/A | N/A | N/A | N/A |
| BNC National Bank | 83,187 | 17.45 | 21,448 | ≥4.50 | 30,980 | 6.50 | 52,207 | 10.95 |
| **Tier 1 Leverage Capital**: | | | | | | | | |
| Consolidated | 79,773 | 9.00 | 35,471 | ≥4.00 | N/A | N/A | N/A | N/A |
| BNC National Bank | 83,187 | 9.45 | 35,212 | ≥4.00 | 44,015 | 5.00 | 39,172 | 4.45 |
| **Tangible Common Equity** (to total assets): | | | | | | | | |
| Consolidated | 68,860 | 7.62 | N/A | N/A | N/A | N/A | N/A | N/A |
| BNC National Bank | 87,733 | 9.71 | N/A | N/A | N/A | N/A | N/A | N/A |

The CET 1 ratio, which is generally a comparison of a bank's core equity capital with its total risk weighted assets, is a measure of the current risk profile of our asset base from a regulatory perspective. The Tier 1 leverage ratio, which is calculated by dividing Tier 1 capital by average total assets, does not consider the mix of risk weighted assets. In recent periods, regulators have required Tier 1 leverage ratios that significantly exceed "Well Capitalized" ratio levels. As a result, management believes the Bank's Tier 1 leverage ratio is our most restrictive capital measurement and we are managing the Tier 1 leverage ratio to levels significantly above the "Well Capitalized" ratio threshold.

Beginning January 1, 2016, the regulators instituted a new capital conservation buffer that places limitations on distributions, including dividend payments. In order to avoid limitations, the Bank must hold a fully phased-in capital conservation buffer of 2.5% above our minimum risk based capital requirements. As of September 30, 2016, there were no distribution restrictions placed on the Bank.

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

The Company routinely evaluates the sufficiency of capital in order to ensure compliance with regulatory capital standards and be a source of strength for the Bank. We manage capital by assessing the composition of capital and the amounts available for growth, risk or other purposes.

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

We refer to "we", "our", "BNC", 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", or "BNC Bank" when referring only to BNC National Bank. Where not otherwise indicated below, financial condition and results of operation discussed are of BNCCORP, INC.

## Comparison of Results for the Three and Nine Months Ended September 30, 2016 and 2015

### Summary for the Three Months Ended September 30, 2016 and 2015

Net income and net income available to common shareholders was $2.259 million, or $0.64 per diluted share, for the quarter ended September 30, 2016. This compared to net income of $1.875 million and net income available to common shareholders of $1.400 million, or $0.40 per diluted share, in the third quarter of 2015.

Net interest income for the third quarter of 2016 was $6.632 million, an increase of $527 thousand, or 8.6%, from $6.105 million for the same period of 2015. The net interest margin for the current period increased to 3.05% from 2.91% a year ago. Growth in loans held for investment resulted in higher yields on earning assets and improved the net interest margin.

Interest income was $7.408 million for the quarter ended September 30, 2016 compared to $6.662 million for the third quarter of 2015. This increase is the result of higher yields on higher average earning assets. The yield on average interest earning assets increased to 3.41% from 3.17% in the same quarter of 2015. During the third quarter of 2016, the average balance of interest earning assets increased by $32.7 million when compared to the third quarter of 2015. Average loans held for investment increased $57.8 million, or 16.7%, and average loans held for sale increased by $16.1 million, in the third quarter of 2016 compared to the same quarter in 2015. The average balance of investment securities decreased by $26.0 million in the third quarter of 2016, compared to the same period a year ago yet generated $121 thousand incremental interest income in the quarter due to higher yields on taxable investment securities. Yields on investment securities increased to 2.07% in the third quarter of 2016 from 1.84% in the same period of 2015.

Interest expense in the third quarter of 2016 was $776 thousand, an increase of $219 thousand from the same period in 2015. The cost of interest bearing liabilities increased to 0.45% in the current quarter from 0.35% in the same period of 2015, primarily due to the issuance of subordinated debt in the fourth quarter of 2015, and an increase in retail certificates of deposit balances in recent quarters. The cost of these liabilities was partially offset by redeeming callable brokered certificates of deposit in the second quarter of 2015 and first half of 2016. The costs related to the redemptions of brokered deposits aggregated $233 thousand in 2016. The cost of core deposits was 0.24% in the third quarter of 2016 and 0.16% in the third quarter of 2015, due largely to higher balances of retail certificates of deposit, which generally have higher rates than non-maturity deposits. Average interest bearing core deposits, which excludes brokered deposits, increased $33.5 million, or 5.8%, during the third quarter of 2016 compared to the third quarter of 2015.

Total loans held for investment increased by $69.5 million, or 20.2%, from September 30, 2015 and increased by $33.2 million, or 8.8%, from December 31, 2015. In addition, mortgage loans held for sale increased $13.2 million at September 30, 2016 compared to December 31, 2015.

Total deposits decreased by $25.1 million to $755.4 million at September 30, 2016 from $780.4 million at December 31, 2015 due largely to the redemption of $33.4 million of callable brokered certificates of deposit in the first nine months of 2016. Core deposits, which excludes brokered deposits, increased $9.7 million to $770.6 million at September 30, 2016 from December 31, 2015 and $42.7 million from September 30, 2015.

Other borrowings increased $52.1 million at September 30, 2016 compared to December 31, 2015 as the Company has generally utilized Federal Home Loan Bank short term advances, averaging 0.55%, in the third quarter of 2016 to fund mortgage banking loans held for sale. The short-term nature of Federal Home Loan Bank advances provide flexibility for the Company to manage the balance sheet.

A $400 thousand provision for credit losses was recorded in the third quarter of 2016. A reversal of previous provisions for credit losses, reflecting a recovery of a previously charged off loan, increased pre-tax earnings by $400 thousand in the third quarter of 2015. In the third quarter of 2016, we charged off $437 thousand of loan balances related to one oil service related relationship. The recent decreases in North Dakota commodity prices are adversely affecting activity in certain sectors of the economy. While we have yet to have a significant negative impact on our nonperforming asset ratio and delinquency credit quality metrics, prolonged depressed oil and commodity prices could have an adverse impact on the North Dakota economy. Loans outstanding for the purpose of and secured by oil exploration and production (E&P) loans in North Dakota were approximately $9.6 million, or 2.3%, of total loans held for investment at September 30, 2016, compared to $11.7 million, or 3.1%, of loans held for investment at December 31, 2015. Advances on E&P lines are generally limited to 50% of the value of proven, developed and producing oil reserves and other advance guidelines used by BNC Bank to comply with regulatory guidance related to E&P loans. Such loans are generally subject to semi-annual valuations. In addition to E&P loans, loans to customers serving the energy industries will be impacted by protracted low energy prices. Customers in, or serving the North Dakota agricultural sector have been experiencing lower commodity prices for multiple years which has had a dampening effect on economic activity in the region.

Non-interest income for the third quarter of 2016 was $7.759 million. This compares to non-interest income of $5.232 million for the same period in 2015, an increase of $2.527 million, or 48.3%. Mortgage banking revenues aggregated $6.163 million in the current period compared to $3.663 million in the third quarter of 2015.

Non-interest expense for the third quarter of 2016 was $10.718 million compared to $8.980 million in the same period of 2015, an increase of $1.738 million. This increase is primarily related to mortgage banking, legal costs, and investments to serve our customers and support growth.

In the third quarter of 2016, we recorded tax expense of $1.014 million which resulted in an effective tax rate of 31.0% for the quarter. A tax expense of $882 thousand was recognized during the third quarter of 2015, which resulted in an effective tax rate of 32.0%.

### Summary for the Nine Months Ended September 30, 2016 and 2015

Net income and the net income available to common shareholders was $5.709 million, or $1.62 per share on a diluted basis, for the nine months ended September 30, 2016. For the nine months ended September 30, 2015, net income was $7.376 million, and the net income available to common shareholders was $5.952 million, or $1.70 per share on a diluted basis.

Net interest income for the nine months ended September 30, 2016 was $19.390 million, an increase of $262 thousand, from $19.128 million for the same period of 2015. The year to date net interest margin increased to 3.02% from 2.96% a year ago.

Interest income increased by $937 thousand in the first nine months of 2016 despite a $8.6 million decrease in the average balance of interest earning assets. Increased average loans held for investment offset the effects of lower average investment balances. Average loans held for investment increased $45.2 million, or 12.9%, compared to the first nine months of the prior year. Average loans held for sale were $47.4 million year-to-date in 2016 compared to $50.4 million in the same period of 2015. The average balance of investment securities decreased by $30.2 million in the first nine months of 2016 compared to the same period a year ago as the Company redeemed brokered deposits and funded loan growth. The yield on earning assets increased to 3.42% in the nine month period ended September 30, 2016 compared to 3.24% in the same period of 2015.

Overall, the net interest margin increased to 3.02% in the first nine months of 2016 from 2.96% in the first nine months of 2015, driven by loans held for investment growth. On a tax equivalent basis, the net interest margin increased to 3.20% for the first nine months of 2016 from 3.12% in the first nine months of 2015 due to the tax exempt status of recent period investments in tax exempt municipal securities.

Interest expense during the first nine months of 2016 increased to $2.539 million from $1.864 million, or 36.2%, in the same period of 2015. In the first nine months of 2016 and 2015, BNC submitted notices to redeem $33.4 million and $20.0 million, respectively, of callable brokered certificates of deposit, at a cost of $233 thousand and $87 thousand, respectively. Excluding the costs to redeem these brokered deposits, interest expense increased by $529 thousand in 2016 compared to 2015. The cost of interest bearing liabilities increased to 0.50% in the first nine months of 2016 from 0.38% in the same period of 2015, primarily due to the issuance of subordinated debt in the fourth quarter of 2015, and an increase in retail certificates of deposit balances, partially offset by the effects of redeeming brokered deposits. The cost of core deposits increased to 0.22% in the first nine months of 2016 from 0.16% in the first nine months of 2015 as retail certificates of deposits have increased in recent quarters.

An $800 thousand provision for credit losses was taken in the first nine months of 2016. A reversal of previous provisions for credit losses, reflecting a recovery of a previously charged off loan, increased pre-tax earnings by $400 thousand in the first nine months of 2015. Charge-offs of $766 thousand have been recorded year-to-date 2016 and recoveries for the same period were $39 thousand.

Non-interest income for the nine months ended September 30, 2016 was $20.905 million. This compares to non-interest income of $19.623 million for the same period in 2015, an increase of $1.282 million, or 6.5%. The increase primarily relates to a $2.745 million, or 20.9%, increase in mortgage revenue, which is partially offset by a decrease in gains on sales of assets of $1.475 million. During the first nine months of 2016, we recorded a net gain on sales of investments of $729 thousand, compared to a $1.732 million net gain on sales of investments in the same period of 2015. The first nine months of 2016 included gains on sales of SBA loans of $233 thousand, compared to $705 thousand in the same period of 2015. Gains on sales of SBA loans have declined as the Company's loan growth has recently favored conventional loans. Gains and losses on sales of assets can vary significantly from period to period.

Non-interest expense for the nine months ended September 30, 2016 was $31.192 million compared to $28.304 million in the same period of 2015, an increase of $2.888 million, or 10.2%. This increase is primarily related to mortgage banking, legal costs, and investments to serve our customers and support growth.

During the nine month period ended September 30, 2016, we recorded tax expense of $2.594 million which resulted in an effective tax rate of 31.2% on a year-to-date basis. A tax expense of $3.471 million was recognized during the nine month period ended September 30, 2015, which resulted in an effective tax rate of 32.0%.

## 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, | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2016 | | | 2015 | | | 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 | $ 1,270 | $ 1 | 0.31% | $ 18,196 | $ 8 | 0.17% | $ (16,926) | $ (7) | 0.14% (a) |
| Investments - taxable | 322,330 | 1,485 | 1.83% | 349,085 | 1,340 | 1.52% | (26,755) | 145 | 0.31% (b) |
| Investments - tax exempt | 90,805 | 665 | 2.91% | 88,367 | 689 | 3.09% | 2,438 | (24) | -0.18% (b) |
| Loans held for sale – mortgage banking | 54,949 | 450 | 3.26% | 38,820 | 368 | 3.76% | 16,129 | 82 | -0.50% (c) |
| Loans and leases held for investment | 404,783 | 4,807 | 4.72% | 346,985 | 4,257 | 4.87% | 57,798 | 550 | -0.15% (d) |
| Allowance for loan losses | (8,730) | - | | (8,724) | - | | (6) | - | |
| Total interest-earning assets | $ 865,407 | $ 7,408 | 3.41% | $ 832,729 | $ 6,662 | 3.17% | $ 32,678 | $ 746 | 0.24% |
| **Interest-bearing liabilities** | | | | | | | | | |
| Interest checking and money market | $ 419,071 | $ 142 | 0.13% | $ 423,018 | $ 133 | 0.12% | $ (3,947) | $ 9 | 0.01% (e) |
| Savings | 31,916 | 2 | 0.02% | 30,620 | 2 | 0.03% | 1,296 | - | -0.01% (e) |
| Certificates of deposit under $100,000 | 58,014 | 180 | 1.23% | 84,552 | 288 | 1.35% | (26,538) | (108) | -0.12% (e) |
| Certificates of deposit $100,000 and over | 93,621 | 145 | 0.62% | 58,606 | 63 | 0.43% | 35,015 | 82 | 0.19% (e) |
| Total interest-bearing deposits | 602,622 | 469 | 0.31% | 596,796 | 486 | 0.32% | 5,826 | (17) | -0.01% |
| Short-term borrowings | 12,959 | 5 | 0.15% | 15,401 | 6 | 0.15% | (2,442) | (1) | 0.00% (f) |
| Federal Home Loan Bank advances | 45,856 | 63 | 0.55% | 1,900 | 1 | 0.21% | 43,956 | 62 | 0.34% (g) |
| Long-term borrowings | 10,000 | 159 | 6.33% | - | - | 0.00% | 10,000 | 159 | 6.33% (h) |
| Subordinated debentures | 15,014 | 80 | 2.12% | 15,016 | 64 | 1.69% | (2) | 16 | 0.43% |
| Total borrowings | 83,829 | 307 | 1.46% | 32,317 | 71 | 0.87% | 51,512 | 236 | 0.59% |
| Total interest-bearing liabilities | $ 686,451 | 776 | 0.45% | $ 629,113 | 557 | 0.35% | $ 57,338 | 219 | 0.10% |
| Net interest income/spread | | $ 6,632 | 2.96% | | $ 6,105 | 2.82% | | $ 527 | 0.14% |
| Net interest margin | | | 3.05% | | | 2.91% | | | 0.14% |
| Notation: | | | | | | | | | |
| Non-interest-bearing deposits | $ 145,983 | - | | $ 157,719 | - | | $ (11,736) | - | (e) |
| Total deposits | $ 748,605 | $ 469 | 0.25% | $ 754,515 | $ 486 | 0.26% | $ (5,910) | $ (17) | -0.01% |
| Taxable equivalents: | | | | | | | | | |
| Total interest-earning assets | $ 865,407 | $ 7,771 | 3.57% | $ 832,729 | $ 7,038 | 3.35% | $ 32,678 | $ 733 | 0.22% |
| Net interest income/spread | - | $ 6,995 | 3.12% | - | $ 6,481 | 3.00% | - | $ 514 | 0.12% |
| Net interest margin | - | - | 3.22% | - | - | 3.09% | - | - | 0.13% |

(a) Cash balances can fluctuate from period to period.
(b) Investment portfolio balances have declined as brokered certificates of deposit were redeemed and loans held for investment were funded. Portfolio reallocation in recent periods has emphasized tax exempt securities and defensive variable rate SBA securities.
(c) The average balance of loans held for sale has risen in 2016 due to favorable mortgage market conditions and growth investments in the mortgage business.
(d) The average balance of loans held for investment has risen in 2016 due to increased activity in our core market areas.
(e) Overall deposit balances have decreased primarily due to redemption of brokered certificates of deposit. In the first and third quarters of 2016, BNC redeemed $18.8 million and $14.6 million, respectively, of higher rate callable brokered certificates of deposit. The redemption of brokered certificates of deposit and decreased non-interest bearing deposits was partially offset by increased retail certificates of 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) Federal Home Loan Bank short term advances have been utilized to flexibly manage our balance sheet.
(h) Subordinated long term debt was issued in the fourth quarter of 2015 to partially fund the redemption of preferred stock.

| | Nine Months Ended September 30, | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2016 | | | 2015 | | | 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 | $ 2,187 | $ 10 | 0.61% | $ 24,199 | $ 41 | 0.23% | $ (22,012) | $ (31) | 0.38% (a) |
| Investments - taxable | 327,459 | 4,668 | 1.90% | 362,968 | 4,964 | 1.83% | (35,509) | (296) | 0.07% (b) |
| Investments - tax exempt | 91,714 | 2,030 | 2.96% | 85,115 | 1,995 | 3.13% | 6,599 | 35 | -0.17% (b) |
| Loans held for sale – mortgage banking | 47,406 | 1,181 | 3.33% | 50,445 | 1,299 | 3.44% | (3,039) | (118) | -0.11% (c) |
| Loans and leases held for investment | 396,245 | 14,040 | 4.73% | 351,047 | 12,693 | 4.83% | 45,198 | 1,347 | -0.10% (d) |
| Allowance for loan losses | (8,533) | - | | (8,690) | - | | 157 | - | |
| Total interest-earning assets | $ 856,478 | $ 21,929 | 3.42% | $ 865,084 | $ 20,992 | 3.24% | $ (8,606) | $ 937 | 0.18% |
| **Interest-bearing liabilities** | | | | | | | | | |
| Interest checking and money market | $ 424,669 | $ 416 | 0.13% | $ 434,474 | $ 396 | 0.12% | $ (9,805) | $ 20 | 0.01% (e) |
| Savings | 32,029 | 7 | 0.03% | 29,406 | 7 | 0.03% | 2,623 | - | 0.00% (e) |
| Certificates of deposit under $100,000 | 72,187 | 919 | 1.70% | 96,169 | 1,030 | 1.43% | (23,982) | (111) | 0.27% (e) |
| Certificates of deposit $100,000 and over | 78,641 | 340 | 0.58% | 60,660 | 217 | 0.48% | 17,981 | 123 | 0.10% (e) |
| Total interest-bearing deposits | 607,526 | 1,682 | 0.37% | 620,709 | 1,650 | 0.36% | (13,183) | 32 | 0.01% |
| Short-term borrowings | 13,500 | 16 | 0.16% | 16,432 | 20 | 0.16% | (2,932) | (4) | 0.00% (f) |
| Federal Home Loan Bank advances | 35,804 | 137 | 0.51% | 3,830 | 8 | 0.28% | 31,974 | 129 | 0.23% (g) |
| Long-term borrowings | 10,000 | 475 | 6.34% | - | - | 0.00% | 10,000 | 475 | 6.34% (h) |
| Subordinated debentures | 15,015 | 229 | 2.04% | 15,017 | 186 | 1.66% | (2) | 43 | 0.38% |
| Total borrowings | 74,319 | 857 | 1.54% | 35,279 | 214 | 0.81% | 39,040 | 643 | 0.73% |
| Total interest-bearing liabilities | $ 681,845 | 2,539 | 0.50% | $ 655,988 | 1,864 | 0.38% | $ 25,857 | 675 | 0.12% |
| Net interest income/spread | | $ 19,390 | 2.92% | | $ 19,128 | 2.86% | | $ 262 | 0.06% |
| Net interest margin | | | 3.02% | | | 2.96% | | | 0.06% |
| Notation: | | | | | | | | | |
| Non-interest-bearing deposits | $ 145,062 | - | | $ 163,987 | - | | $ (18,925) | - | (e) |
| Total deposits | $ 752,588 | $ 1,682 | 0.30% | $ 784,696 | $ 1,650 | 0.28% | $ (32,108) | $ 32 | 0.02% |
| Taxable equivalents: | | | | | | | | | |
| Total interest-earning assets | $ 856,478 | $ 23,035 | 3.59% | $ 865,084 | $ 22,082 | 3.41% | $ (8,606) | $ 953 | 0.18% |
| Net interest income/spread | - | $ 20,496 | 3.09% | - | $ 20,218 | 3.03% | - | $ 278 | 0.06% |
| Net interest margin | - | - | 3.20% | - | - | 3.12% | - | - | 0.08% |

(a) Cash balances can fluctuate from period to period.
(b) Investment portfolio balances have declined as we redeemed brokered deposits and funded loans held for investment. Portfolio reallocation has emphasized tax exempt securities and defensive variable rate SBA securities.
(c) The average balance of loans held for sale decreased marginally, however, remained strong in 2016.
(d) The average balance of loans held for investment has risen in 2016 due to increased activity in our core market areas.
(e) Overall deposit balances have decreased due to brokered certificates of deposit redemptions of $33.4 million and $20.0 million in the first nine months of 2016 and 2015, respectively. The redemption of brokered certificates of deposit and decreased non-interest bearing deposits was partially offset by increased retail certificates of 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) Federal Home Loan Bank short term advances have been utilized to flexibly manage our balance sheet.
(h) Subordinated debt was issued in the fourth quarter of 2015 to partially fund the redemption of preferred stock.

## Non-interest Income

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

| | Three Months Ended September 30, | | Increase (Decrease) | | Nine Months Ended September 30, | | Increase (Decrease) | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2016 | 2015 | $ | % | 2016 | 2015 | $ | % | |
| Bank charges and service fees | $ 700 | $ 761 | $ (61) | (8) % | $ 2,063 | $ 2,185 | $ (122) | (6) % | |
| Wealth management revenues | 373 | 355 | 18 | 5 % | 1,156 | 1,127 | 29 | 3 % | |
| Mortgage banking revenues | 6,163 | 3,663 | 2,500 | 68 % | 15,892 | 13,147 | 2,745 | 21 % | (a) |
| Gains on sales of loans, net | 10 | 133 | (123) | (92) % | 233 | 705 | (472) | (67) % | (b) |
| Gains on sales of securities, net | 292 | 172 | 120 | 70 % | 729 | 1,732 | (1,003) | (58) % | (c) |
| Other | 221 | 148 | 73 | 49 % | 832 | 727 | 105 | 14 % | |
| Total non-interest income | $ 7,759 | $ 5,232 | $ 2,527 | 48 % | $ 20,905 | $ 19,623 | $ 1,282 | 7 % | |

(a) Mortgage banking revenues have increased due to the continued low interest rate environment, investments in loan producers and our ability to capture loan volume through our existing platforms.

(b) Gains on sales of SBA loans have declined as the Company’s loan growth has recently favored conventional loans. Gains on sale of loans can vary significantly from period to period.

(c) Gains and losses on sales of securities may vary significantly from period to period.

## Non-interest Expense

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

| | Three Months Ended September 30, | | Increase (Decrease) | | Nine Months Ended September 30, | | Increase (Decrease) | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2016 | 2015 | $ | % | 2016 | 2015 | $ | % | |
| Salaries and employee benefits | $ 5,619 | $ 4,317 | $ 1,302 | 30 % | $ 16,400 | $ 14,996 | $ 1,404 | 9 % | (a) |
| Professional services | 1,236 | 1,039 | 197 | 19 % | 3,460 | 2,891 | 569 | 20 % | (b) |
| Data processing fees | 932 | 788 | 144 | 18 % | 2,739 | 2,290 | 449 | 20 % | (c) |
| Marketing and promotion | 924 | 1,044 | (120) | (11) % | 2,826 | 2,600 | 226 | 9 % | |
| Occupancy | 551 | 507 | 44 | 9 % | 1,620 | 1,457 | 163 | 11 % | (d) |
| Regulatory costs | 168 | 176 | (8) | (5) % | 502 | 523 | (21) | (4) % | |
| Depreciation and amortization | 397 | 358 | 39 | 11 % | 1,118 | 1,062 | 56 | 5 % | |
| Office supplies and postage | 164 | 153 | 11 | 7 % | 513 | 492 | 21 | 4 % | |
| Other real estate costs | - | 1 | (1) | (100) % | 22 | 16 | 6 | 38 % | (e) |
| Other | 727 | 597 | 130 | 22 % | 1,992 | 1,977 | 15 | 1 % | |
| Total non-interest expense | $ 10,718 | $ 8,980 | $ 1,738 | 19 % | $ 31,192 | $ 28,304 | $ 2,888 | 10 % | |
| Efficiency ratio | 74.5% | 79.2% | | | 77.4% | 73.0% | | | |

(a) Salaries and benefits reflect a new branch in North Dakota and investments in producers and functions supporting growth.

(b) The increase of professional services is primarily due to an increase in legal costs in 2016.

(c) Data processing fees have increased due to continued investment in information technology.

(d) Occupancy increased due to higher maintenance costs on existing locations and an increase in locations and expansion of existing space for our loan production offices.

(e) Other real estate costs will vary from period to period depending on valuation adjustments on our foreclosed properties– see Note 6. At September 30, 2016, the Company held one property in other real estate.

## Income Taxes

In the third quarter of 2016, we recorded tax expense of $1.014 million which resulted in an effective tax rate of 31.0% for the quarter. A tax expense of $882 thousand was recognized during the third quarter of 2015, which resulted in an effective tax rate of 32.0%.

During the nine month period ended September 30, 2016, we recorded a tax expense of $2.594 million, equating to an effective tax rate of 31.2%. We recorded tax expense of $3.471 million during the nine month period ended September 30, 2015, which resulted in an effective tax rate of 32.0%. The decrease in the year-to-date effective tax rate is due to a higher percentage of tax exempt income than in the same period of 2015.

# Comparison of Financial Condition at September 30, 2016 and December 31, 2015

## Assets

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

| | September 30, 2016 | December 31, 2015 | Increase (Decrease) $ | Increase (Decrease) % | |
|---|---|---|---|---|---|
| Cash and cash equivalents | $ 11,265 | $ 15,189 | $ (3,924) | (26) % | (a) |
| Investment securities available for sale | 409,719 | 419,346 | (9,627) | (2) % | |
| Federal Reserve Bank and Federal Home Loan Bank of Des Moines stock | 5,211 | 3,219 | 1,992 | 62 % | (b) |
| Loans held for sale-mortgage banking | 63,614 | 50,445 | 13,169 | 26 % | (c) |
| Loans and leases held for investment, net | 413,151 | 379,903 | 33,248 | 9 % | (d) |
| Allowance for credit losses | (8,684) | (8,611) | (73) | 1 % | |
| Other real estate, net | 225 | 242 | (17) | (7) % | (e) |
| Premises and equipment, net | 19,055 | 17,574 | 1,481 | 8 % | |
| Accrued interest receivable | 3,677 | 4,027 | (350) | (9) % | |
| Other assets | 25,360 | 22,912 | 2,448 | 11 % | (f) |
| Total assets | $ 942,593 | $ 904,246 | $ 38,347 | 4 % | |

(a) Cash balances can fluctuate significantly.
(b) The increase in FHLB stock varies in proportion to the level of FHLB advances outstanding.
(c) Loans held for sale increased as mortgage loan funding increased late in the first quarter of 2016 and has continued to be strong through the third quarter of 2016.
(d) Loans held for investment balances have risen in 2016 due to continued loan production in our core market areas.
(e) The decrease in other real estate, net is due to an increase in the other real estate owned reserve. See Note 6.
(f) The fair value of mortgage banking derivatives increased $3.6 million as our pipeline of mortgage loan activity has been elevated throughout 2016.

## 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 $188.3 million as of September 30, 2016 and $176.4 million as of December 31, 2015. 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):

| | September 30, 2016 | | December 31, 2015 | |
|---|---|---|---|---|
| North Dakota | $ 289,040 | 70 % | $ 259,271 | 68 % |
| Arizona | 63,967 | 15 % | 68,796 | 18 % |
| Minnesota | 27,757 | 7 % | 26,022 | 7 % |
| Other | 32,205 | 8 % | 25,766 | 7 % |
| Total gross loans held for investment | $ 412,969 | 100 % | $ 379,855 | 100 % |

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):

| | September 30, 2016 | | December 31, 2015 | |
|---|---|---|---|---|
| North Dakota | $ 270,924 | 66 % | $ 244,797 | 65 % |
| Arizona | 82,872 | 20 % | 83,086 | 22 % |
| Minnesota | 19,147 | 5 % | 10,685 | 3 % |
| California | 10,542 | 3 % | 10,837 | 3 % |
| Colorado | 9,199 | 2 % | 9,197 | 2 % |
| Ohio | 8,515 | 2 % | 8,732 | 2 % |
| Other | 11,770 | 2 % | 12,521 | 3 % |
| Total gross loans held for investment | $ 412,969 | 100 % | $ 379,855 | 100 % |

## Loan Maturities[(1)]

The following table sets forth the remaining maturities of loans in each major category of our portfolio as of September 30, 2016 (in thousands):

| | | Over 1 year through 5 years | | Over 5 years | | Total Loans and Leases |
|---|---|---|---|---|---|---|
| | One year or less | Fixed Rate | Floating Rate | Fixed Rate | Floating rate | Held for Investment |
| Commercial and industrial | $ 16,433 | $ 451 | $ 29,731 | $ 40,502 | $ 37,616 | $ 124,733 |
| Commercial real estate | 696 | 7,084 | 8,287 | 26,193 | 130,462 | 172,722 |
| SBA | 557 | - | 6,339 | 2,153 | 20,753 | 29,802 |
| Consumer | 1,670 | 24 | 4,148 | 44,560 | 7,306 | 57,708 |
| Land and land development | 300 | 676 | 2,553 | 6,825 | 5,422 | 15,776 |
| Construction | 1,917 | 2,447 | 7,864 | - | - | 12,228 |
| Total principal amount of loans | $ 21,573 | $ 10,682 | $ 58,922 | $ 120,233 | $ 201,559 | $ 412,969 |

(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, 2016 | | December 31, 2015 | |
|---|---|---|---|---|
| | Allocation of Allowance | Loans as a percent of Gross Loans Held for Investment | Allocation of Allowance | Loans as a percent of Gross Loans Held for Investment |
| Commercial and industrial | $ 2,634 | 30 % | $ 3,205 | 33 % |
| Commercial real estate | 3,113 | 42 % | 1,999 | 39 % |
| SBA | 1,506 | 7 % | 1,578 | 7 % |
| Consumer | 791 | 14 % | 640 | 12 % |
| Land and land development | 535 | 4 % | 1,041 | 5 % |
| Construction | 105 | 3 % | 148 | 4 % |
| Total | $ 8,684 | 100 % | $ 8,611 | 100 % |

## Nonperforming Loans

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| Balance, beginning of period | $ 2,341 | $ 722 | $ 565 | $ 61 |
| Additions to nonperforming | 24 | 94 | 2,159 | 937 |
| Charge-offs | (437) | (22) | (532) | (168) |
| Reclassified back to performing | - | (436) | (175) | (455) |
| Principal payment received | (20) | (17) | (109) | (34) |
| Balance, end of period | $ 1,908 | $ 341 | $ 1,908 | $ 341 |

## Nonperforming Assets

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

| | September 30, 2016 | December 31, 2015 |
|---|---|---|
| **Nonperforming loans:** | | |
| Loans 90 days or more delinquent and still accruing interest | $ 2 | $ 175 |
| Non-accrual loans | 1,906 | 390 |
| **Total nonperforming loans** | 1,908 | 565 |
| Other real estate, net | 225 | 242 |
| **Total nonperforming assets** | $ 2,133 | $ 807 |
| Allowance for credit losses | $ 8,684 | $ 8,611 |
| Ratio of total nonperforming loans to total loans | 0.40% | 0.13% |
| Ratio of total nonperforming loans to loans and leases held for investment | 0.46% | 0.15% |
| Ratio of total nonperforming assets to total assets | 0.23% | 0.09% |
| Ratio of nonperforming loans to total assets | 0.20% | 0.06% |
| Ratio of allowance for credit losses to nonperforming loans | 455% | 1,524% |

## Potential Problem Loans

We attempt to quantify potential problem loans with more immediate credit risk. At September 30, 2016, the Bank had $9.2 million of classified loans and $1.9 million of loans on non-accrual. This compares to $9.8 million of classified loans and $390 thousand of loans on non-accrual at December 31, 2015 and $8.5 million of classified loans and $341 thousand of loans on non-accrual at September 30, 2015. We estimate there are loans risk rated “watch list” which are not impaired aggregating $10.9 million at September 30, 2016 and $7.9 million at December 31, 2015. Also, we estimate there are loans risk rated “substandard” which are not impaired aggregating $7.3 million at September 30, 2016 and $9.4 million at December 31, 2015.

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 6 of our Financial Statements for information on other real estate owned.

## Liabilities

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

| | September 30, 2016 | December 31, 2015 | Increase (Decrease) $ | Increase (Decrease) % | |
|---|---|---|---|---|---|
| Deposits: | | | | | |
| Non-interest-bearing | $ 150,051 | $ 168,259 | $ (18,208) | (11) % | (a) |
| Interest-bearing- | | | | | |
| Savings, interest checking and money market | 453,837 | 460,385 | (6,548) | (1) % | (a) |
| Time deposits under $100,000 | 59,511 | 86,817 | (27,306) | (31) % | (b) |
| Time deposits $100,000 and over | 91,965 | 64,988 | 26,977 | 42 % | (c) |
| Short-term borrowings | 15,227 | 13,851 | 1,376 | 10 % | |
| Federal Home Loan Bank advances | 58,000 | 7,300 | 50,700 | 695 % | (d) |
| Long-term borrowings | 10,000 | 10,000 | - | - % | |
| Guaranteed preferred beneficial interests in Company's subordinated debentures | 15,014 | 15,015 | (1) | - % | |
| Accrued interest payable | 729 | 487 | 242 | 50 % | (e) |
| Accrued expenses | 8,265 | 7,398 | 867 | 12 % | |
| Other liabilities | 2,151 | 758 | 1,393 | 184 % | (f) |
| Total liabilities | $ 864,750 | $ 835,258 | $ 29,492 | 4 % | |

(a) Non-interest bearing and savings deposits have decreased as customers deployed funds previously deposited in our North Dakota branches.
(b) In the first nine months of 2016 BNC redeemed $33.4 million of higher rate callable brokered certificates of deposit.
(c) BNC has increased retail certificates of deposits, primarily in North Dakota.
(d) The Company has borrowed on a short-term basis from the Federal Home Loan Bank as an efficient source of liquidity for mortgage loans held for sale.
(e) The increase is primarily due to accrued interest on the subordinated debt, issued in October 2015, and growth in retail certificates of deposit.
(f) Other liabilities increased primarily due to increases in deferred tax liabilities as the investment portfolio's unrealized gain increased in 2016 and an increase in the fair value of mortgage banking commitments to sell.

## Mortgage Banking Obligations

Included in accrued expenses is an estimate of mortgage banking reimbursement obligations which aggregated $1.5 million at September 30, 2016 and $1.8 million at December 31, 2015. 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 due to faulty representation and generally emerge at varied timeframes subsequent to the original sale of the loan. To estimate the contingent 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, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| Balance, beginning of period | $ 1,640 | $ 2,102 | $ 1,781 | $ 1,879 |
| Provision | 40 | 139 | 90 | 498 |
| Write offs, net | (140) | (298) | (331) | (434) |
| Balance, end of period | $ 1,540 | $ 1,943 | $ 1,540 | $ 1,943 |

## Stockholders' Equity

Our stockholders' equity increased $8.9 million between December 31, 2015 and September 30, 2016 primarily due to $5.7 million in additional retained earnings and an increase in unrealized gains and losses in our investment portfolio of $2.9 million. As presented in Note 16 – Regulatory Capital and Current Operating Environment, the Company maintains capital in excess of regulatory requirements.

The Company routinely evaluates the sufficiency of its capital in order to ensure compliance with regulatory capital standards and be a source of strength for the Bank. We manage capital by assessing the composition of capital and amounts available for growth, risk or other purposes. In recent periods, capital has grown through retention of earnings and the Company has reduced certain higher cost forms of capital such as the redemption in 2014 of $7.5 million in Guaranteed Preferred Beneficial Interests in Subordinated Debt costing 12.05% and the redemption in 2015 of $21.1 million of Series A and B Preferred Stock costing 9%. Management will continue to evaluate capital requirements and prudent capital management opportunities.

## 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 ($130.5 million as of September 30, 2016);
2. Borrowing capacity from the FHLB ($97.8 million as of September 30, 2016); and
3. Capacity to issue brokered deposits with maturities of less than 12 months ($130.3 million as of September 30, 2016).

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.

## 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, 2016 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, 2016 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, 2016, 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 3.50% to 4.50% 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 | -100bp | Unchanged | +100bp | +200bp | +300bp | +400bp |
|---|---|---|---|---|---|---|
| Projected 12-month net interest income | $ 28,023 | $ 28,548 | $ 28,140 | $ 27,699 | $ 27,258 | $ 27,063 |
| Dollar change from unchanged scenario | $ (525) | $ - | $ (408) | $ (849) | $ (1,290) | $ (1,485) |
| Percentage change from unchanged scenario | (1.84)% | - | (1.43)% | (2.97)% | (4.52)% | (5.20)% |

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, 2016 (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, 2016. 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, 2016 | | | | |
|---|---|---|---|---|---|
| | 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 | $ 11,265 | $ - | $ - | $ - | $ 11,265 |
| Investment securities (a) | 113,471 | 12,837 | 99,032 | 136,106 | 361,446 |
| FRB and FHLB stock | 5,211 | - | - | - | 5,211 |
| Fed funds sold | - | - | - | - | - |
| Loans held for sale-mortgage banking, fixed rate | - | 63,614 | - | - | 63,614 |
| Loans held for sale-mortgage banking, floating rate | - | - | - | - | - |
| Loans held for investment, fixed rate | 9,154 | 19,943 | 76,734 | 32,260 | 138,091 |
| Loans held for investment, indexed rate | 81,210 | 10,598 | 179,822 | 3,430 | 275,060 |
| Total interest-earning assets | $ 220,311 | $ 106,992 | $ 355,588 | $ 171,796 | $ 854,687 |
| **Interest-bearing liabilities:** | | | | | |
| Interest checking and money market accounts | $ 421,527 | $ - | $ - | $ - | $ 421,527 |
| Savings | 32,310 | - | - | - | 32,310 |
| Time deposits under $100,000 | 21,142 | 19,068 | 18,875 | 426 | 59,511 |
| Time deposits $100,000 and over | 48,064 | 28,564 | 15,132 | 205 | 91,965 |
| Short-term borrowings | 15,227 | - | - | - | 15,227 |
| FHLB advances | 58,000 | - | - | - | 58,000 |
| Long-term borrowings | - | - | - | 10,000 | 10,000 |
| Subordinated debentures | 15,000 | - | - | 14 | 15,014 |
| Total interest-bearing liabilities | $ 611,270 | $ 47,632 | $ 34,007 | $ 10,645 | $ 703,554 |
| Interest rate gap | $ (390,959) | $ 59,360 | $ 321,581 | $ 161,151 | $ 151,133 |
| Cumulative interest rate gap at September 30, 2016 | $ (390,959) | $ (331,599) | $ (10,018) | $ 151,133 | |
| Cumulative interest rate gap to total assets | (41.37)% | (34.85)% | (1.05)% | 16.03% | |

(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, 2016 and do not contemplate any actions we might undertake in response to changes in market interest rates.

# OTHER INFORMATION

## 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 10, 2016 | By: | /s/ Timothy J. Franz |
| | | | Timothy J. Franz<br>President and Chief Executive Officer |
| | | By: | /s/ Daniel J. Collins |
| | | | Daniel J. Collins<br>Chief Financial Officer |