

HMN FINANCIAL INC  
Form 10-Q  
November 07, 2012

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2012

OR

.. **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15 (d) FOR THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from            to

Commission File Number 0-24100

**HMN FINANCIAL, INC.**

(Exact name of Registrant as specified in its Charter)

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**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**41-1777397**  
(I.R.S. Employer  
Identification Number)

**1016 Civic Center Drive N.W., Rochester, MN**  
(Address of principal executive offices)

**55901**  
(ZIP Code)

**Registrant's telephone number, including area code: (507) 535-1200**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

(Check one):

Large accelerated filer  Accelerated filer   
Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company   
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of the latest practicable date.

| Class                          | Outstanding at October 18, 2012 |
|--------------------------------|---------------------------------|
| Common stock, \$0.01 par value | 4,423,589                       |

HMN FINANCIAL, INC.

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**Part I FINANCIAL INFORMATION****Item 1: Financial Statements****HMN FINANCIAL, INC. AND SUBSIDIARIES****Consolidated Balance Sheets**

| <i>(Dollars in thousands)</i>   | September 30,<br>2012<br>(unaudited) | December 31,<br>2011 |
|---|--------------------------------------|----------------------|
| <b>Assets</b>   |                                      |                      |
| Cash and cash equivalents   | \$ 76,400                            | 67,840               |
| Securities available for sale:  |                                      |                      |
| Mortgage-backed and related securities (amortized cost \$11,629 and \$19,586)             | 12,437                               | 20,645               |
| Other marketable securities (amortized cost \$46,736 and \$105,700)                       | 46,406                               | 105,469              |
|   | 58,843                               | 126,114              |
| Loans held for sale   | 4,654                                | 3,709                |
| Loans receivable, net   | 474,346                              | 555,908              |
| Accrued interest receivable   | 2,135                                | 2,449                |
| Real estate, net  | 12,617                               | 16,616               |
| Federal Home Loan Bank stock, at cost   | 4,063                                | 4,222                |
| Mortgage servicing rights, net  | 1,580                                | 1,485                |
| Premises and equipment, net   | 7,359                                | 7,967                |
| Prepaid expenses and other assets   | 1,726                                | 2,262                |
| Assets held for sale  | 0                                    | 1,583                |
| Deferred tax asset, net   | 0                                    | 0                    |
| <b>Total assets</b>   | <b>\$ 643,723</b>                    | <b>790,155</b>       |
| <b>Liabilities and Stockholders' Equity</b>   |                                      |                      |
| Deposits  | \$ 505,541                           | 620,128              |
| Deposits held for sale  | 0                                    | 36,048               |
| Federal Home Loan Bank advances   | 70,000                               | 70,000               |
| Accrued interest payable  | 237                                  | 780                  |
| Customer escrows  | 1,422                                | 933                  |
| Accrued expenses and other liabilities  | 6,674                                | 5,205                |
| <b>Total liabilities</b>  | <b>583,874</b>                       | <b>733,094</b>       |
| Commitments and contingencies   |                                      |                      |
| Stockholders' equity:   |                                      |                      |
| Serial preferred stock: (\$.01 par value) authorized 500,000 shares; issued shares 26,000 | 25,193                               | 24,780               |
| Common stock (\$.01 par value): authorized 11,000,000; issued shares 9,128,662            | 91                                   | 91                   |
| Additional paid-in capital  | 51,990                               | 53,462               |
| Retained earnings, subject to certain restrictions  | 45,844                               | 42,983               |
| Accumulated other comprehensive income  | 122                                  | 471                  |
| Unearned employee stock ownership plan shares   | (3,045)                              | (3,191)              |
| Treasury stock, at cost 4,705,073 and 4,740,711 shares                                    | (60,346)                             | (61,535)             |
| <b>Total stockholders' equity</b>   | <b>59,849</b>                        | <b>57,061</b>        |
| <b>Total liabilities and stockholders' equity</b>   | <b>\$ 643,723</b>                    | <b>790,155</b>       |

See accompanying notes to consolidated financial statements.

## HMN FINANCIAL, INC. AND SUBSIDIARIES

## Consolidated Statements of Comprehensive Income (Loss)

(unaudited)

|  | Three Months Ended<br>September 30, |                | Nine Months Ended<br>September 30, |                |
|--|-------------------------------------|----------------|------------------------------------|----------------|
|  | 2012                                | 2011           | 2012                               | 2011           |
| <i>(Dollars in thousands, except per share data)</i>       |                                     |                |                                    |                |
| <b>Interest income:</b>                                    |                                     |                |                                    |                |
| Loans receivable   | \$ 7,208                            | 8,967          | 22,527                             | 28,171         |
| <b>Securities available for sale:</b>                      |                                     |                |                                    |                |
| Mortgage-backed and related                                | 133                                 | 259            | 490                                | 873            |
| Other marketable   | 160                                 | 308            | 601                                | 1,132          |
| Cash equivalents   | 25                                  | 4              | 71                                 | 7              |
| Other  | 25                                  | 34             | 89                                 | 148            |
| <b>Total interest income</b>                               | <b>7,551</b>                        | <b>9,572</b>   | <b>23,778</b>                      | <b>30,331</b>  |
| <b>Interest expense:</b>                                   |                                     |                |                                    |                |
| Deposits   | 804                                 | 1,623          | 3,082                              | 5,369          |
| Federal Home Loan Bank advances                            | 855                                 | 865            | 2,544                              | 3,434          |
| <b>Total interest expense</b>                              | <b>1,659</b>                        | <b>2,488</b>   | <b>5,626</b>                       | <b>8,803</b>   |
| <b>Net interest income</b>                                 | <b>5,892</b>                        | <b>7,084</b>   | <b>18,152</b>                      | <b>21,528</b>  |
| Provision for loan losses                                  | 1,584                               | 4,260          | 2,544                              | 9,669          |
| <b>Net interest income after provision for loan losses</b> | <b>4,308</b>                        | <b>2,824</b>   | <b>15,608</b>                      | <b>11,859</b>  |
| <b>Non-interest income:</b>                                |                                     |                |                                    |                |
| Fees and service charges                                   | 821                                 | 978            | 2,484                              | 2,827          |
| Mortgage servicing fees                                    | 245                                 | 247            | 713                                | 747            |
| Gain on sales of loans                                     | 940                                 | 188            | 2,469                              | 984            |
| Gain on sale of branch office                              | 0                                   | 0              | 552                                | 0              |
| Other  | 110                                 | 106            | 398                                | 336            |
| <b>Total non-interest income</b>                           | <b>2,116</b>                        | <b>1,519</b>   | <b>6,616</b>                       | <b>4,894</b>   |
| <b>Non-interest expense:</b>                               |                                     |                |                                    |                |
| Compensation and benefits                                  | 2,955                               | 3,276          | 9,587                              | 10,348         |
| (Gain) loss on real estate owned                           | (172)                               | 111            | (75)                               | 301            |
| Occupancy  | 805                                 | 930            | 2,526                              | 2,786          |
| Deposit insurance  | 353                                 | 190            | 928                                | 1,001          |
| Data processing  | 333                                 | 326            | 1,006                              | 884            |
| Other  | 1,513                               | 1,565          | 4,416                              | 5,362          |
| <b>Total non-interest expense</b>                          | <b>5,787</b>                        | <b>6,398</b>   | <b>18,388</b>                      | <b>20,682</b>  |
| <b>Income (loss) before income tax expense</b>             | <b>637</b>                          | <b>(2,055)</b> | <b>3,836</b>                       | <b>(3,929)</b> |
| Income tax expense   | 0                                   | 0              | 0                                  | 0              |
| <b>Net income (loss)</b>                                   | <b>\$ 637</b>                       | <b>(2,055)</b> | <b>3,836</b>                       | <b>(3,929)</b> |
| Preferred stock dividends and discount                     | 467                                 | 456            | 1,392                              | 1,362          |

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|   |         |         |       |         |
|---|---------|---------|-------|---------|
| Net income (loss) for common shareholders                       | 170     | (2,511) | 2,444 | (5,291) |
| Other comprehensive income (loss), net of tax                   | (77)    | (130)   | (349) | 194     |
| Comprehensive income (loss) attributable to common shareholders | 93      | (2,641) | 2,095 | (5,097) |
| Basic earnings (loss) per common share                          | \$ 0.04 | (0.65)  | 0.62  | (1.38)  |
| Diluted earnings (loss) per common share                        | \$ 0.04 | (0.65)  | 0.61  | (1.38)  |

See accompanying notes to consolidated financial statements.

## HMN FINANCIAL, INC. AND SUBSIDIARIES

## Consolidated Statement of Stockholders Equity

For the Nine-Month Period Ended September 30, 2012

(unaudited)

| <i>(Dollars in thousands)</i>                 | Preferred<br>Stock | Common<br>Stock | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income | Unearned<br>Employee<br>Stock<br>Ownership<br>Plan<br>Shares | Treasury<br>Stock | Total<br>Stock-<br>Holders<br>Equity |
|---|--------------------|-----------------|----------------------------------|----------------------|---|--|-------------------|--------------------------------------|
| Balance, December 31, 2011                    | \$ 24,780          | 91              | 53,462                           | 42,983               | 471   | (3,191)  | (61,535)          | 57,061                               |
| Net income                                    |                    |                 |                                  | 3,836                |   |  |                   | 3,836                                |
| Other comprehensive loss                      |                    |                 |                                  |                      | (349)   |  |                   | (349)                                |
| Preferred stock discount amortization         | 413                |                 | (413)                            |                      |   |  |                   | 0                                    |
| Stock compensation tax benefits               |                    |                 | 6                                |                      |   |  |                   | 6                                    |
| Unearned compensation restricted stock awards |                    |                 | (1,199)                          |                      |   |  | 1,199             | 0                                    |
| Restricted stock awards forfeited             |                    |                 | 10                               |                      |   |  | (10)              | 0                                    |
| Amortization of restricted stock awards       |                    |                 | 183                              |                      |   |  |                   | 183                                  |
| Preferred stock dividends accrued             |                    |                 |                                  | (975)                |   |  |                   | (975)                                |
| Earned employee stock ownership plan shares   |                    |                 | (59)                             |                      |   | 146  |                   | 87                                   |
| Balance, September 30, 2012                   | \$ 25,193          | 91              | 51,990                           | 45,844               | 122   | (3,045)  | (60,346)          | 59,849                               |

See accompanying notes to consolidated financial statements.



## HMN FINANCIAL, INC. AND SUBSIDIARIES

## Consolidated Statements of Cash Flows

(unaudited)

| <i>(Dollars in thousands)</i>   | Nine Months Ended<br>September 30, |                 |
|---|------------------------------------|-----------------|
|   | 2012                               | 2011            |
| <b>Cash flows from operating activities:</b>  |                                    |                 |
| Net income (loss)   | \$ 3,836                           | (3,929)         |
| <b>Adjustments to reconcile net income (loss) to cash provided by operating activities:</b> |                                    |                 |
| Provision for loan losses   | 2,544                              | 9,669           |
| Depreciation  | 833                                | 955             |
| Amortization of premiums, net   | 79                                 | 236             |
| Amortization of deferred loan fees  | (359)                              | (412)           |
| Amortization of mortgage servicing rights, net  | 548                                | 357             |
| Capitalized mortgage servicing rights   | (643)                              | (218)           |
| (Gain) loss on real estate  | (75)                               | 301             |
| Gains on sales of loans   | (2,469)                            | (984)           |
| Proceeds from sale of loans held for sale   | 91,025                             | 34,813          |
| Disbursements on loans held for sale  | (81,510)                           | (30,667)        |
| Amortization of restricted stock awards   | 183                                | 225             |
| Amortization of unearned ESOP shares  | 146                                | 145             |
| Earned employee stock ownership shares priced below original cost                           | (59)                               | (60)            |
| Stock option compensation   | 6                                  | 22              |
| Decrease in accrued interest receivable   | 314                                | 735             |
| Decrease in accrued interest payable  | (543)                              | (377)           |
| Decrease in other assets  | 572                                | 1,017           |
| Increase (decrease) in accrued expenses and other liabilities                               | (1,375)                            | 137             |
| Other, net  | 114                                | 243             |
| <b>Net cash provided by operating activities</b>  | <b>13,167</b>                      | <b>12,208</b>   |
| <b>Cash flows from investing activities:</b>  |                                    |                 |
| Principal collected on securities available for sale  | 7,963                              | 9,623           |
| Proceeds collected on maturities of securities available for sale                           | 103,000                            | 132,000         |
| Purchases of securities available for sale  | (44,037)                           | (134,051)       |
| Purchase of Federal Home Loan Bank Stock  | 0                                  | (17)            |
| Redemption of Federal Home Loan Bank Stock  | 159                                | 2,538           |
| Proceeds from sales of real estate  | 5,870                              | 3,378           |
| Net decrease in loans receivable  | 69,693                             | 50,671          |
| Gain on sale of branch office   | (552)                              | 0               |
| Payment on sale of branch office  | (36,981)                           | 0               |
| Purchases of premises and equipment   | (221)                              | (183)           |
| <b>Net cash provided by investing activities</b>  | <b>104,894</b>                     | <b>63,959</b>   |
| <b>Cash flows from financing activities:</b>  |                                    |                 |
| Decrease in deposits  | (109,992)                          | (6,969)         |
| Proceeds from borrowings  | 0                                  | 10,000          |
| Repayment of borrowings   | 0                                  | (62,500)        |
| Increase in customer escrows  | 491                                | 632             |
| <b>Net cash used by financing activities</b>  | <b>(109,501)</b>                   | <b>(58,837)</b> |

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|  |           |        |
|--|-----------|--------|
| Increase in cash and cash equivalents                        | 8,560     | 17,330 |
| Cash and cash equivalents, beginning of period               | 67,840    | 20,981 |
| Cash and cash equivalents, end of period                     | \$ 76,400 | 38,311 |
| Supplemental cash flow disclosures:                          |           |        |
| Cash paid for interest                                       | \$ 6,169  | 9,181  |
| Cash paid for income taxes                                   | 10        | 0      |
| Supplemental noncash flow disclosures:                       |           |        |
| Transfer of loans to real estate                             | 1,895     | 8,682  |
| Loans transferred to loans held for sale                     | 7,955     | 4,366  |
| Assets transferred to assets held for sale                   | 0         | 1,512  |
| Deposits transferred to deposits held for sale               | 0         | 45,838 |
| See accompanying notes to consolidated financial statements. |           |        |

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**HMN FINANCIAL, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements**

(unaudited)

**September 30, 2012 and 2011**

**(1) HMN Financial, Inc.**

HMN Financial, Inc. (HMN or the Company) is a stock savings bank holding company that owns 100 percent of Home Federal Savings Bank (the Bank). The Bank has a community banking philosophy and operates retail banking and loan production offices in Minnesota and Iowa. The Bank has one wholly owned subsidiary, Osterud Insurance Agency, Inc. (OIA), which offers financial planning products and services. HMN has another wholly owned subsidiary, Security Finance Corporation (SFC), which is currently not actively engaged in any activities.

The consolidated financial statements included herein are for HMN, SFC, the Bank and OIA. All significant intercompany accounts and transactions have been eliminated in consolidation.

**(2) Basis of Preparation**

The accompanying unaudited consolidated financial statements were prepared in accordance with instructions for Form 10-Q and therefore, do not include all disclosures necessary for a complete presentation of the consolidated balance sheets, consolidated statements of comprehensive income (loss), consolidated statement of stockholders' equity and consolidated statements of cash flows in conformity with U.S. generally accepted accounting principles. However, all normal recurring adjustments which are, in the opinion of management, necessary for the fair presentation of the interim financial statements have been included. The results of operations for the nine-month period ended September 30, 2012 is not necessarily indicative of the results which may be expected for the entire year.

**(3) New Accounting Standards**

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

In May 2011, the FASB issued ASU 2011-04, *Fair Value Measurement (Topic 820), Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. The amendments in this ASU change the wording used to describe the requirements in U.S. GAAP for measuring fair value and for disclosing information about fair value measurements in order to improve consistency in wording between U.S. GAAP and IFRS. Also, the amendments in the ASU require that for each class of assets and liabilities not measured at fair value on the balance sheet but for which the fair value is disclosed, the Company shall disclose the fair value hierarchy for each asset and liability class. This ASU is effective for interim or annual period beginning on or after December 15, 2011. The adoption of this ASU in the first quarter of 2012 did not have a material impact on the Company's consolidated financial statements other than to change the disclosures relating to fair value measurements.

In June 2011, the FASB issued ASU 2011-05, *Comprehensive Income (Topic 220), Presentation of Comprehensive Income*. Prior to this ASU, U.S. GAAP allowed reporting entities three alternatives for presenting other comprehensive income and its components in financial statements. The first two options were to present this information in a single continuous statement of comprehensive income or in two separate but consecutive statements. The third option, which was used by the Company, was to present the components of other comprehensive income as part of the statement of changes in stockholders' equity. This ASU eliminates the third option and therefore the Company selected to present this information in a single continuous statement of comprehensive income. This ASU is effective for fiscal years, and interim periods beginning after December 15, 2011. The adoption of this ASU in the first quarter of 2012 did not have a material impact on the Company's consolidated financial statements other than to change the presentation of other comprehensive income as discussed above.



In December 2011, the FASB issued ASU 2011-11, *Balance Sheet (Topic 210)*. The objective of this ASU is to provide enhanced disclosures that will enable users of its financial statements to evaluate the effect or potential effect of rights of setoff associated with an entity's financial position. This includes the effect or potential effect of rights of setoff associated with an entity's recognized assets and recognized liabilities within the scope of this ASU. The amendments require enhanced disclosures by requiring improved information about financial instruments and derivative instruments that are either (1) offset in accordance with either Section 210-20-45 or Section 815-10-45 or (2) subject to an enforceable master netting arrangement or similar agreement, irrespective of whether they are offset in accordance with either Section 210-20-45 or Section 815-10-45. An entity is required to apply the amendments for annual reporting periods beginning on or after January 1, 2013, and interim periods with those annual periods. The adoption of this ASU in the first quarter of 2013 is not anticipated to have any impact on the Company's consolidated financial statements as it currently has no outstanding rights of setoff.

In December 2011, the FASB issued ASU 2011-12, *Comprehensive Income (Topic 220)*. The amendments in this ASU supersede certain pending paragraphs in ASU 2011-05, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income*, to effectively defer only those changes in ASU 2011-05 that relate to the presentation of reclassification adjustments out of accumulated other comprehensive income. All other requirements in ASU 2011-05 are not affected by this ASU, including the requirement to report comprehensive income either in a single continuous financial statement or in two separate but consecutive financial statements. The amendments in this ASU will be temporary to allow the FASB time to redeliberate the presentation requirements for reclassifications out of accumulated other comprehensive income for annual and interim financial statements for public, private, and non-profit entities. The adoption of this ASU in the first quarter of 2012 did not have a material impact on the Company's consolidated financial statements other than to change the presentation of other comprehensive income as discussed above.

#### **(4) Derivative Instruments and Hedging Activities**

The Company has commitments outstanding to extend credit to future borrowers that have not closed prior to the end of the quarter. The Company intends to sell these commitments, which are referred to as its mortgage pipeline. As commitments to originate loans enter the mortgage pipeline, the Company generally enters into commitments to sell the mortgage pipeline into the secondary market on a firm commitment or best efforts basis. The commitments to originate, purchase or sell loans on a firm commitment basis are derivatives. As a result of marking to market the mortgage pipeline and the related firm commitments to sell for the period ended September 30, 2012, the Company recorded an increase in other assets of \$36,000, an increase in other liabilities of \$38,000 and a loss included in the gains on sales of loans of \$2,000.

The current commitments to sell loans held for sale are derivatives that do not qualify for hedge accounting. As a result, these derivatives are marked to market and the related loans held for sale are recorded at the lower of cost or market. The Company recorded an increase in other liabilities of \$41,000 and a loss included in the gain on sales of loans of \$41,000.

#### **(5) Fair Value Measurements**

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

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

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

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

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The following table summarizes the assets and liabilities of the Company for which fair values are determined on a recurring basis as of September 30, 2012 and December 31, 2011.

| <i>(Dollars in thousands)</i> | Carrying value at September 30, 2012 |            |               |          |
|-------------------------------|--------------------------------------|------------|---------------|----------|
|                               | Total                                | Level 1    | Level 2       | Level 3  |
| Securities available for sale | \$ 58,843                            | 105        | 58,738        | 0        |
| Mortgage loan commitments     | (173)                                | 0          | (173)         | 0        |
| <b>Total</b>                  | <b>\$ 58,670</b>                     | <b>105</b> | <b>58,565</b> | <b>0</b> |

| <i>(Dollars in thousands)</i> | Carrying value at December 31, 2011 |            |                |          |
|-------------------------------|-------------------------------------|------------|----------------|----------|
|                               | Total                               | Level 1    | Level 2        | Level 3  |
| Securities available for sale | \$ 126,114                          | 613        | 125,501        | 0        |
| Mortgage loan commitments     | (94)                                | 0          | (94)           | 0        |
| <b>Total</b>                  | <b>\$ 126,020</b>                   | <b>613</b> | <b>125,407</b> | <b>0</b> |

There were no transfers between Levels 1, 2, or 3 during the three or nine month periods ended September 30, 2012.

The Company may also be required, from time to time, to measure certain other financial assets at fair value on a nonrecurring basis in accordance with generally accepted accounting principles. These adjustments to fair value usually result from the application of the lower-of-cost-or-market accounting or write-downs of individual assets. For assets measured at fair value on a nonrecurring basis in the third quarter of 2012 that were still held at September 30, 2012, the following table provides the level of valuation assumptions used to determine each adjustment and the carrying value of the related individual assets or portfolios at September 30, 2012 and December 31, 2011.

| <i>(Dollars in thousands)</i>   | Carrying value at September 30, 2012 |          |               |          |                    |                   |  |
|---------------------------------|--------------------------------------|----------|---------------|----------|--------------------|-------------------|--|
|                                 | Total                                | Level 1  | Level 2       | Level 3  | Three months ended | Nine months ended |  |
|                                 |                                      |          |               |          | September 30,      | September         |  |
|                                 |                                      |          |               |          | 2012               | 30, 2012          |  |
| Total gains                     | Total gains                          |          |               |          |                    |                   |  |
| (losses)                        | (losses)                             |          |               |          |                    |                   |  |
| Loans held for sale             | \$ 4,654                             | 0        | 4,654         | 0        | 71                 | 41                |  |
| Mortgage servicing rights       | 1,580                                | 0        | 1,580         | 0        | 0                  | 0                 |  |
| Loans <sup>(1)</sup>            | 36,847                               | 0        | 36,847        | 0        | (859)              | (2,232)           |  |
| Real estate, net <sup>(2)</sup> | 12,617                               | 0        | 12,617        | 0        | 0                  | (399)             |  |
| <b>Total</b>                    | <b>\$ 55,698</b>                     | <b>0</b> | <b>55,698</b> | <b>0</b> | <b>(788)</b>       | <b>(2,590)</b>    |  |

| <i>(Dollars in thousands)</i>   | Carrying value at December 31, 2011 |         |         |         |  |  |
|---------------------------------|-------------------------------------|---------|---------|---------|--|--|
|                                 | Total                               | Level 1 | Level 2 | Level 3 | Year ended<br>December 31, 2011<br>Total<br>gains (losses) |  |
| Loans held for sale             | \$ 3,709                            | 0       | 3,709   | 0       | 129  |  |
| Mortgage servicing rights       | 1,485                               | 0       | 1,485   | 0       | 0  |  |
| Loans <sup>(1)</sup>            | 38,162                              | 0       | 38,162  | 0       | (4,167)  |  |
| Real estate, net <sup>(2)</sup> | 16,616                              | 0       | 16,616  | 0       | (2,690)  |  |
| Assets held for sale            | 1,583                               | 0       | 1,583   | 0       | 0  |  |
| Deposits held for sale          | 36,048                              | 0       | 36,048  | 0       | 0  |  |

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|       |           |   |        |   |         |
|-------|-----------|---|--------|---|---------|
| Total | \$ 97,603 | 0 | 97,603 | 0 | (6,728) |
|-------|-----------|---|--------|---|---------|

- (1) Represents the carrying value and related specific reserves on loans for which adjustments are based on the appraised value of the collateral. The carrying value of loans fully charged-off is zero.
- (2) Represents the fair value and related losses of foreclosed real estate and other collateral owned that were measured at fair value subsequent to their initial classification as foreclosed assets.

**(6) Fair Value of Financial Instruments**

Generally accepted accounting principles require interim reporting period disclosure about the fair value of financial instruments, including assets, liabilities and off-balance sheet items for which it is practicable to estimate fair value. The fair value hierarchy level for each asset and liability, as defined in note 5, have been included in the following table for September 30, 2012 as required by the adoption of ASU 2011-04 in the first quarter of 2012. The fair value estimates are made based upon relevant market information, if available, and upon the characteristics of the financial instruments themselves. Because no market exists for a significant portion of the Company's financial instruments, fair value estimates are based upon judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments and other factors. The estimated fair value of the Company's financial instruments as of September 30, 2012 and December 31, 2011 are shown below.

| (Dollars in thousands)                          | September 30, 2012 |                      |                      | December 31, 2011 |         |                 |                 |                      |                 |
|---|--------------------|----------------------|----------------------|-------------------|---------|-----------------|-----------------|----------------------|-----------------|
|   | Carrying amount    | Estimated fair value | Fair value hierarchy |                   |         | Contract amount | Carrying amount | Estimated fair value | Contract Amount |
|   |                    |                      | Level 1              | Level 2           | Level 3 |                 |                 |                      |                 |
| <b>Financial assets:</b>                        |                    |                      |                      |                   |         |                 |                 |                      |                 |
| Cash and cash equivalents                       | \$ 76,400          | 76,400               | 76,400               |                   |         |                 | 67,840          | 67,840               |                 |
| Securities available for sale                   | 58,843             | 58,843               | 105                  | 58,738            |         |                 | 126,114         | 126,114              |                 |
| Loans held for sale                             | 4,654              | 4,654                |                      | 4,654             |         |                 | 3,709           | 3,709                |                 |
| Loans receivable, net                           | 474,346            | 480,115              |                      | 480,115           |         |                 | 555,908         | 566,266              |                 |
| Federal Home Loan Bank stock                    | 4,063              | 4,063                |                      | 4,063             |         |                 | 4,222           | 4,222                |                 |
| Accrued interest receivable                     | 2,135              | 2,135                |                      | 2,135             |         |                 | 2,449           | 2,449                |                 |
| Assets held for sale                            | 0                  | 0                    |                      |                   |         |                 | 1,583           | 1,605                |                 |
| <b>Financial liabilities:</b>                   |                    |                      |                      |                   |         |                 |                 |                      |                 |
| Deposits  | 505,541            | 505,541              |                      | 505,541           |         |                 | 620,128         | 620,128              |                 |
| Deposits held for sale                          | 0                  | 0                    |                      |                   |         |                 | 36,048          | 36,048               |                 |
| Federal Home Loan Bank advances                 | 70,000             | 72,375               |                      | 72,375            |         |                 | 70,000          | 74,433               |                 |
| Accrued interest payable                        | 237                | 237                  |                      | 237               |         |                 | 780             | 780                  |                 |
| <b>Off-balance sheet financial instruments:</b> |                    |                      |                      |                   |         |                 |                 |                      |                 |
| Commitments to extend credit                    | 64                 | 64                   |                      |                   |         | 90,970          | 29              | 29                   | 91,113          |
| Commitments to sell loans                       | (173)              | (173)                |                      |                   |         | 10,240          | (94)            | (94)                 | 7,263           |
| <i>Cash and Cash Equivalents</i>                |                    |                      |                      |                   |         |                 |                 |                      |                 |

The carrying amount of cash and cash equivalents approximates their fair value.

*Securities Available for Sale*

The fair values of securities were based upon quoted market prices for identical or similar instruments in active markets.

*Loans Held for Sale*

The fair values of loans held for sale were based upon quoted market prices for loans with similar interest rates and terms to maturity.

*Loans Receivable*

The fair values of loans receivable were estimated for groups of loans with similar characteristics. The fair value of the loan portfolio, with the exception of the adjustable rate portfolio, was calculated by discounting the scheduled cash flows through the estimated maturity using anticipated prepayment speeds and using discount rates that reflect the credit and interest rate risk inherent in each loan portfolio. The fair value of the adjustable loan portfolio was estimated by grouping the loans with similar characteristics and comparing the characteristics of each group to the prices quoted for similar types of loans in the secondary market. This method of estimating fair value does not incorporate the exit-price concept of fair value prescribed by ASC 820, Fair Value Measurements and Disclosures.

*Federal Home Loan Bank Stock*

The carrying amount of FHLB stock approximates its fair value.



*Accrued Interest Receivable*

The carrying amount of accrued interest receivable approximates its fair value since it is short-term in nature and does not present unanticipated credit concerns.

*Deposits*

The fair value of demand deposits, savings accounts and certain money market account deposits is the amount payable on demand at the reporting date. The fair value of fixed maturity certificates of deposit is estimated using the rates currently offered for deposits of similar remaining maturities. If the fair value of the fixed maturity certificates of deposit is calculated at less than the carrying amount, the carrying value of these deposits is reported as the fair value.

The fair value estimate for deposits does not include the benefit that results from the low cost funding provided by the Company's existing deposits and long-term customer relationships compared to the cost of obtaining different sources of funding. This benefit is commonly referred to as the core deposit intangible.

*Federal Home Loan Bank Advances*

The fair values of advances with fixed maturities are estimated based on discounted cash flow analysis using as discount rates the interest rates charged by the FHLB for borrowings of similar remaining maturities.

*Accrued Interest Payable*

The carrying amount of accrued interest payable approximates its fair value since it is short-term in nature.

*Commitments to Extend Credit*

The fair values of commitments to extend credit are estimated using the fees normally charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counter parties.

*Commitments to Sell Loans*

The fair values of commitments to sell loans are estimated using the quoted market prices for loans with similar interest rates and terms to maturity.

**(7) Comprehensive Income (Loss)**

Other comprehensive income (loss) is defined as the change in equity during a period from transactions and other events from nonowner sources. Comprehensive income (loss) is the total of net income (loss) and other comprehensive income (loss), which for the Company is comprised of unrealized gains and losses on securities available for sale. The components of other comprehensive income (loss) and the related tax effects were as follows:

| <i>(Dollars in thousands)</i>                   | For the three months ended September 30, |            |            |            |            |            |
|---|--|------------|------------|------------|------------|------------|
|   | 2012                                     |            |            | 2011       |            |            |
|   | Before tax                               | Tax effect | Net of tax | Before tax | Tax effect | Net of tax |
| Securities available for sale:                  |  |            |            |            |            |            |
| Net unrealized losses arising during the period | \$ (77)                                  | 0          | (77)       | (130)      | 0          | (130)      |
| Other comprehensive loss                        | \$ (77)                                  | 0          | (77)       | (130)      | 0          | (130)      |

| <i>(Dollars in thousands)</i>                           | For the nine months ended September 30, |            |            |            |            |            |
|---|---|------------|------------|------------|------------|------------|
|   | 2012                                    |            |            | 2011       |            |            |
|   | Before tax                              | Tax effect | Net of tax | Before tax | Tax effect | Net of tax |
| Securities available for sale:                          |   |            |            |            |            |            |
| Net unrealized gains (losses) arising during the period | \$ (349)                                | 0          | (349)      | 194        | 0          | 194        |
| Other comprehensive income (loss)                       | \$ (349)                                | 0          | (349)      | 194        | 0          | 194        |

**(8) Securities Available For Sale**

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The following table shows the gross unrealized losses and fair value for the securities available for sale portfolio, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at September 30, 2012 and December 31, 2011.

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| (Dollars in thousands)                | Less than twelve months |           |            | September 30, 2012<br>Twelve months or more |        |            | Total     |            |
|---------------------------------------|-------------------------|-----------|------------|---|--------|------------|-----------|------------|
|                                       | #                       | Fair      | Unrealized | #   | Fair   | Unrealized | Fair      | Unrealized |
|                                       | of                      | Value     | Losses     | of  | Value  | Losses     | Value     | Losses     |
| Investments                           |                         |           |            | Investments                                 |        |            |           |            |
| Other marketable securities:          |                         |           |            |   |        |            |           |            |
| U.S. Government agency obligations    | 3                       | \$ 15,028 | (9)        | 0   | \$ 0   | 0          | \$ 15,028 | (9)        |
| Corporate preferred stock             | 0                       | 0         | 0          | 1   | 245    | (455)      | 245       | (455)      |
| Total temporarily impaired securities | 3                       | \$ 15,028 | (9)        | 1   | \$ 245 | (455)      | \$ 15,273 | (464)      |

| (Dollars in thousands)                | Less than twelve months |       |            | December 31, 2011<br>Twelve months or more |        |            | Total  |            |
|---------------------------------------|-------------------------|-------|------------|--|--------|------------|--------|------------|
|                                       | #                       | Fair  | Unrealized | #  | Fair   | Unrealized | Fair   | Unrealized |
|                                       | of                      | Value | Losses     | of   | Value  | Losses     | Value  | Losses     |
| Investments                           |                         |       |            | Investments                                |        |            |        |            |
| Other marketable securities:          |                         |       |            |  |        |            |        |            |
| Corporate preferred stock             | 0                       | \$ 0  | 0          | 1  | \$ 175 | (525)      | \$ 175 | (525)      |
| Total temporarily impaired securities | 0                       | \$ 0  | 0          | 1  | \$ 175 | (525)      | \$ 175 | (525)      |

We review our investment portfolio on a quarterly basis for indications of impairment. This review includes analyzing the length of time and the extent to which the fair value has been lower than the cost, the market liquidity for the investment, the financial condition and near-term prospects of the issuer, including any specific events which may influence the operations of the issuer, and our intent and ability to hold the investment for a period of time sufficient to recover the temporary loss.

The unrealized losses reported for corporate preferred stock at September 30, 2012 and December 31, 2011 related to a single trust preferred security that was issued by the holding company of a small community bank. Typical of most trust preferred issuances, the issuer has the ability to defer interest payments for up to five years with interest payable on the deferred balance. In October 2009, the issuer elected to defer its scheduled interest payments as allowed by the terms of the security agreement. The issuer's subsidiary bank has incurred operating losses due to increased provisions for loan losses but still meets the regulatory requirements to be considered adequately capitalized based on its most recent regulatory filing. Based on a review of the issuer, it was determined that the trust preferred security was not other-than-temporarily impaired at September 30, 2012. The Company does not intend to sell the preferred stock and has the intent and ability to hold it for a period of time sufficient to recover the temporary loss. Management believes that the Company will receive all principal and interest payments contractually due on the security and that the decrease in the market value is primarily due to a lack of liquidity in the market for trust preferred securities and the deferral of interest by the issuer. Management will continue to monitor the credit risk of the issuer and may be required to recognize other-than-temporary impairment charges on this security in future periods.

A summary of securities available for sale at September 30, 2012 and December 31, 2011 is as follows:

| (Dollars in thousands)               | Amortized cost | Gross unrealized gains | Gross unrealized losses | Fair value |
|--------------------------------------|----------------|------------------------|-------------------------|------------|
| <u>September 30, 2012:</u>           |                |                        |                         |            |
| Mortgage-backed securities:          |                |                        |                         |            |
| FHLMC                                | \$ 6,700       | 437                    | 0                       | 7,137      |
| FNMA                                 | 4,824          | 371                    | 0                       | 5,195      |
| Collateralized mortgage obligations: |                |                        |                         |            |
| FHLMC                                | 105            | 0                      | 0                       | 105        |
|                                      | 11,629         | 808                    | 0                       | 12,437     |
| Other marketable securities:         |                |                        |                         |            |
| U.S. Government agency obligations   | 46,036         | 134                    | (9)                     | 46,161     |
| Corporate preferred stock            | 700            | 0                      | (455)                   | 245        |

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|    |        |     |       |        |
|----|--------|-----|-------|--------|
|    | 46,736 | 134 | (464) | 46,406 |
| \$ | 58,365 | 942 | (464) | 58,843 |

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| <i>(Dollars in thousands)</i>        | Amortized cost | Gross unrealized gains | Gross unrealized losses | Fair value |
|--------------------------------------|----------------|------------------------|-------------------------|------------|
| <b>December 31, 2011:</b>            |                |                        |                         |            |
| Mortgage-backed securities:          |                |                        |                         |            |
| FHLMC                                | \$ 11,310      | 553                    | 0                       | 11,863     |
| FNMA                                 | 7,670          | 499                    | 0                       | 8,169      |
| Collateralized mortgage obligations: |                |                        |                         |            |
| FHLMC                                | 335            | 4                      | 0                       | 339        |
| FNMA                                 | 271            | 3                      | 0                       | 274        |
|                                      | 19,586         | 1,059                  | 0                       | 20,645     |
| Other marketable securities:         |                |                        |                         |            |
| U.S. Government agency obligations   | 105,000        | 294                    | 0                       | 105,294    |
| Corporate preferred stock            | 700            | 0                      | (525)                   | 175        |
|                                      | 105,700        | 294                    | (525)                   | 105,469    |
|                                      | \$ 125,286     | 1,353                  | (525)                   | 126,114    |

The following table indicates amortized cost and estimated fair value of securities available for sale at September 30, 2012 based upon contractual maturity adjusted for scheduled repayments of principal and projected prepayments of principal based upon current economic conditions and interest rates.

| <i>(Dollars in thousands)</i>          | Amortized Cost   | Fair Value    |
|--|------------------|---------------|
| Due less than one year                 | \$ 42,632        | 43,178        |
| Due after one year through five years  | 14,923           | 15,302        |
| Due after five years through ten years | 110              | 118           |
| Due after ten years                    | 700              | 245           |
| <b>Total</b>                           | <b>\$ 58,365</b> | <b>58,843</b> |

The allocation of mortgage-backed securities and collateralized mortgage obligations in the table above is based upon the anticipated future cash flow of the securities using estimated mortgage prepayment speeds. The allocation of other marketable securities that have call features is based on the anticipated cash flows to the call date if it is anticipated that the security will be called, or to the maturity date if it is not anticipated to be called.

**(9) Loans Receivable, Net**

A summary of loans receivable at September 30, 2012 and December 31, 2011 is as follows:

| <i>(Dollars in thousands)</i> | September 30, 2012 | December 31, 2011 |
|-------------------------------|--------------------|-------------------|
| 1-4 family                    | \$ 101,445         | 119,066           |
| Commercial real estate:       |                    |                   |
| Residential developments      | 48,972             | 52,746            |
| Alternative fuels             | 14,497             | 18,882            |
| Other                         | 197,885            | 218,286           |
|                               | 261,354            | 289,914           |
| Consumer                      | 54,898             | 62,161            |
| Commercial business:          |                    |                   |

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|                             |            |         |
|-----------------------------|------------|---------|
| Construction/development    | 545        | 4,786   |
| Banking                     | 1,892      | 4,899   |
| Other                       | 74,944     | 99,574  |
|                             | 77,381     | 109,259 |
| Total loans                 | 495,078    | 580,400 |
| Less:                       |            |         |
| Unamortized discounts       | 48         | 93      |
| Net deferred loan fees      | 222        | 511     |
| Allowance for loan losses   | 20,462     | 23,888  |
| Total loans receivable, net | \$ 474,346 | 555,908 |

**(10) Allowance for Loan Losses and Credit Quality Information**

The allowance for loan losses is summarized as follows:

| <i>(Dollars in thousands)</i>                                | 1-4 Family | Commercial Real Estate | Consumer | Commercial Business | Total   |
|--|------------|------------------------|----------|---------------------|---------|
| <b><u>For the three months ended September 30, 2012:</u></b> |            |                        |          |                     |         |
| Balance, June 30, 2012                                       | \$ 3,665   | 11,553                 | 1,268    | 4,033               | 20,519  |
| Provision for losses   | (621)      | 2,246                  | 4        | (45)                | 1,584   |
| Charge-offs  | 0          | (1,535)                | (164)    | (167)               | (1,866) |
| Recoveries   | 0          | 47                     | 94       | 84                  | 225     |
| Balance, September 30, 2012                                  | \$ 3,044   | 12,311                 | 1,202    | 3,905               | 20,462  |
| <b><u>For the nine months ended September 30, 2012:</u></b>  |            |                        |          |                     |         |
| Balance, December 31, 2011                                   | \$ 3,718   | 13,622                 | 1,159    | 5,389               | 23,888  |
| Provision for losses   | (674)      | 3,037                  | 851      | (670)               | 2,544   |
| Charge-offs  | 0          | (5,719)                | (921)    | (1,996)             | (8,636) |
| Recoveries   | 0          | 1,371                  | 113      | 1,182               | 2,666   |
| Balance, September 30, 2012                                  | \$ 3,044   | 12,311                 | 1,202    | 3,905               | 20,462  |
| <b>Allocated to:</b>   |            |                        |          |                     |         |
| Specific reserves  | \$ 1,086   | 3,559                  | 367      | 1,621               | 6,633   |
| General reserves   | 2,632      | 10,063                 | 792      | 3,768               | 17,255  |
| Balance, December 31, 2011                                   | \$ 3,718   | 13,622                 | 1,159    | 5,389               | 23,888  |
| <b>Allocated to:</b>   |            |                        |          |                     |         |
| Specific reserves  | \$ 584     | 2,028                  | 576      | 1,309               | 4,497   |
| General reserves   | 2,460      | 10,283                 | 626      | 2,596               | 15,965  |
| Balance, September 30, 2012                                  | \$ 3,044   | 12,311                 | 1,202    | 3,905               | 20,462  |
| <b><u>Loans receivable at December 31, 2011:</u></b>         |            |                        |          |                     |         |
| Individually reviewed for impairment                         | \$ 6,241   | 30,495                 | 1,205    | 6,855               | 44,796  |
| Collectively reviewed for impairment                         | 112,825    | 259,419                | 60,956   | 102,404             | 535,604 |
| Ending balance   | \$ 119,066 | 289,914                | 62,161   | 109,259             | 580,400 |
| <b><u>Loans receivable at September 30, 2012:</u></b>        |            |                        |          |                     |         |
| Individually reviewed for impairment                         | \$ 5,644   | 29,314                 | 2,042    | 4,344               | 41,344  |
| Collectively reviewed for impairment                         | 95,801     | 232,040                | 52,856   | 73,037              | 453,734 |
| Ending balance   | \$ 101,445 | 261,354                | 54,898   | 77,381              | 495,078 |
| <b><u>For the three months ended September 30, 2011:</u></b> |            |                        |          |                     |         |
| Balance, June 30, 2011                                       | \$ 3,437   | 15,367                 | 1,154    | 7,806               | 27,764  |
| Provision for losses   | 878        | 2,893                  | 85       | 404                 | 4,260   |
| Charge-offs  | (32)       | (4,094)                | (143)    | (2,167)             | (6,436) |



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|  |    |       |          |       |          |          |
|--|----|-------|----------|-------|----------|----------|
| Recoveries   |    | 0     | 10       | 6     | 86       | 102      |
| Balance, September 30, 2011                          | \$ | 4,283 | 14,176   | 1,102 | 6,129    | 25,690   |
| <u>For the nine months ended September 30, 2011:</u> |    |       |          |       |          |          |
| Balance, December 31, 2010                           | \$ | 2,145 | 24,590   | 924   | 15,169   | 42,828   |
| Provision for losses                                 |    | 2,588 | 5,807    | 392   | 882      | 9,669    |
| Charge-offs  |    | (450) | (16,303) | (230) | (10,724) | (27,707) |
| Recoveries   |    | 0     | 82       | 16    | 802      | 900      |
| Balance, September 30, 2011                          | \$ | 4,283 | 14,176   | 1,102 | 6,129    | 25,690   |

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The following table summarizes the amount of classified and unclassified loans at September 30, 2012 and December 31, 2011:

| <i>(Dollars in thousands)</i> | September 30, 2012 |             |          |      |         | Unclassified<br>Total | Total<br>Loans |
|-------------------------------|--------------------|-------------|----------|------|---------|-----------------------|----------------|
|                               | Special<br>Mention | Substandard | Doubtful | Loss | Total   |                       |                |
| 1-4 family                    | \$ 249             | 16,243      | 60       | 0    | 16,552  | 84,893                | 101,445        |
| Commercial real estate:       |                    |             |          |      |         |                       |                |
| Residential developments      | 775                | 36,219      | 209      | 0    | 37,203  | 11,769                | 48,972         |
| Alternative fuels             | 11,350             | 0           | 0        | 0    | 11,350  | 3,147                 | 14,497         |
| Other                         | 22,489             | 18,123      | 74       | 0    | 40,686  | 157,199               | 197,885        |
| Consumer                      | 0                  | 1,704       | 133      | 205  | 2,042   | 52,856                | 54,898         |
| Commercial business:          |                    |             |          |      |         |                       |                |
| Construction/development      | 0                  | 122         | 0        | 0    | 122     | 423                   | 545            |
| Banking                       | 0                  | 1,892       | 0        | 0    | 1,892   | 0                     | 1,892          |
| Other                         | 7,381              | 7,468       | 286      | 0    | 15,135  | 59,809                | 74,944         |
|                               | \$ 42,244          | 81,771      | 762      | 205  | 124,982 | 370,096               | 495,078        |

| <i>(Dollars in thousands)</i> | December 31, 2011  |             |          |      |         | Unclassified<br>Total | Total<br>Loans |
|-------------------------------|--------------------|-------------|----------|------|---------|-----------------------|----------------|
|                               | Special<br>Mention | Substandard | Doubtful | Loss | Total   |                       |                |
| 1-4 family                    | \$ 8,870           | 11,129      | 738      | 0    | 20,737  | 98,329                | 119,066        |
| Commercial real estate:       |                    |             |          |      |         |                       |                |
| Residential developments      | 444                | 39,709      | 1,113    | 0    | 41,266  | 11,480                | 52,746         |
| Alternative fuels             | 0                  | 0           | 0        | 0    | 0       | 18,882                | 18,882         |
| Other                         | 5,789              | 19,607      | 0        | 0    | 25,396  | 192,890               | 218,286        |
| Consumer                      | 0                  | 857         | 224      | 124  | 1,205   | 60,956                | 62,161         |
| Commercial business:          |                    |             |          |      |         |                       |                |
| Construction/development      | 0                  | 2,722       | 0        | 0    | 2,722   | 2,064                 | 4,786          |
| Banking                       | 0                  | 3,750       | 1,149    | 0    | 4,899   | 0                     | 4,899          |
| Other                         | 3,203              | 8,056       | 0        | 0    | 11,259  | 88,315                | 99,574         |
|                               | \$ 18,306          | 85,830      | 3,224    | 124  | 107,484 | 472,916               | 580,400        |

Classified loans represent special mention, performing substandard and non-performing loans. Loans classified as special mention are loans that have potential weaknesses 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. 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. They 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. A loan classified as loss is considered uncollectible and of such little value that continuance as an asset on the balance sheet is not warranted. Loans classified as substandard or doubtful require the Bank to perform an analysis of the individual loan and charge off any loans, or portion thereof, that are deemed uncollectible.

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The aging of past due loans at September 30, 2012 and December 31, 2011 is summarized as follows:

| <i>(Dollars in thousands)</i>    | 30-59<br>Days<br>Past Due | 60-89<br>Days<br>Past<br>Due | 90 Days<br>or More<br>Past Due | Total<br>Past Due | Current<br>Loans | Total<br>Loans | Loans 90 Days or<br>More Past<br>Due<br>and Still Accruing |
|----------------------------------|---------------------------|------------------------------|--------------------------------|-------------------|------------------|----------------|--|
| <b><u>September 30, 2012</u></b> |                           |                              |                                |                   |                  |                |  |
| 1-4 family                       | \$ 1,737                  | 257                          | 446                            | 2,440             | 99,005           | 101,445        | 0  |
| Commercial real estate:          |                           |                              |                                |                   |                  |                |  |
| Residential developments         | 0                         | 0                            | 293                            | 293               | 48,679           | 48,972         | 0  |
| Alternative fuels                | 0                         | 0                            | 0                              | 0                 | 14,497           | 14,497         | 0  |
| Other                            | 2,827                     | 0                            | 1,150                          | 3,977             | 193,908          | 197,885        | 0  |
| Consumer                         | 325                       | 69                           | 38                             | 432               | 54,466           | 54,898         | 0  |
| Commercial business:             |                           |                              |                                |                   |                  |                |  |
| Construction/development         | 0                         | 0                            | 177                            | 177               | 368              | 545            | 0  |
| Banking                          | 0                         | 0                            | 0                              | 0                 | 1,892            | 1,892          | 0  |
| Other                            | 1,312                     | 0                            | 1,736                          | 3,048             | 71,896           | 74,944         | 0  |
|                                  | \$ 6,201                  | 326                          | 3,840                          | 10,367            | 484,711          | 495,078        | 0  |
| <b><u>December 31, 2011</u></b>  |                           |                              |                                |                   |                  |                |  |
| 1-4 family                       | \$ 1,876                  | 305                          | 1,297                          | 3,478             | 115,588          | 119,066        | 0  |
| Commercial real estate:          |                           |                              |                                |                   |                  |                |  |
| Residential developments         | 107                       | 290                          | 8,211                          | 8,608             | 44,138           | 52,746         | 0  |
| Alternative fuels                | 0                         | 0                            | 0                              | 0                 | 18,882           | 18,882         | 0  |
| Other                            | 350                       | 79                           | 5,184                          | 5,613             | 212,673          | 218,286        | 0  |
| Consumer                         | 658                       | 374                          | 387                            | 1,419             | 60,742           | 62,161         | 0  |
| Commercial business:             |                           |                              |                                |                   |                  |                |  |
| Construction/development         | 286                       | 0                            | 0                              | 286               | 4,500            | 4,786          | 0  |
| Banking                          | 0                         | 0                            | 1,149                          | 1,149             | 3,750            | 4,899          | 0  |
| Other                            | 351                       | 112                          | 2,877                          | 3,340             | 96,234           | 99,574         | 0  |
|                                  | \$ 3,628                  | 1,160                        | 19,105                         | 23,893            | 556,507          | 580,400        | 0  |

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Impaired loans include loans that are non-performing (non-accruing) and loans that have been modified in a troubled debt restructuring (TDR). The following table summarizes impaired loans and related allowances as of September 30, 2012 and December 31, 2011:

| <i>(Dollars in thousands)</i>                    | September 30, 2012  |                          |                   | December 31, 2011   |                          |                   |
|--|---------------------|--------------------------|-------------------|---------------------|--------------------------|-------------------|
|  | Recorded Investment | Unpaid Principal Balance | Related Allowance | Recorded Investment | Unpaid Principal Balance | Related Allowance |
| <b>Loans with no related allowance recorded:</b> |                     |                          |                   |                     |                          |                   |
| 1-4 family                                       | \$ 2,412            | 2,412                    | 0                 | 2,651               | 2,972                    | 0                 |
| <b>Commercial real estate:</b>                   |                     |                          |                   |                     |                          |                   |
| Residential developments                         | 11,937              | 17,995                   | 0                 | 6,900               | 9,855                    | 0                 |
| Alternative fuels                                | 0                   | 0                        | 0                 | 0                   | 0                        | 0                 |
| Other  | 1,017               | 1,115                    | 0                 | 3,745               | 4,381                    | 0                 |
| Consumer   | 393                 | 393                      | 0                 | 489                 | 489                      | 0                 |
| <b>Commercial business:</b>                      |                     |                          |                   |                     |                          |                   |
| Construction/development                         | 0                   | 0                        | 0                 | 340                 | 2,311                    | 0                 |
| Banking  | 0                   | 0                        | 0                 | 1,149               | 3,248                    | 0                 |
| Other  | 1,739               | 6,072                    | 0                 | 598                 | 1,607                    | 0                 |
| <b>Loans with an allowance recorded:</b>         |                     |                          |                   |                     |                          |                   |
| 1-4 family                                       | 3,232               | 3,276                    | 584               | 3,590               | 3,590                    | 1,086             |
| <b>Commercial real estate:</b>                   |                     |                          |                   |                     |                          |                   |
| Residential developments                         | 13,260              | 14,568                   | 1,235             | 13,889              | 14,017                   | 2,546             |
| Alternative fuels                                | 0                   | 0                        | 0                 | 0                   | 0                        | 0                 |
| Other  | 3,100               | 3,450                    | 793               | 5,961               | 8,272                    | 1,013             |
| Consumer   | 1,649               | 1,649                    | 576               | 716                 | 716                      | 367               |
| <b>Commercial business:</b>                      |                     |                          |                   |                     |                          |                   |
| Construction/development                         | 119                 | 2,090                    | 65                | 0                   | 0                        | 0                 |
| Banking  | 0                   | 0                        | 0                 | 0                   | 0                        | 0                 |
| Other  | 2,486               | 3,157                    | 1,244             | 4,768               | 7,145                    | 1,621             |
| <b>Total:</b>                                    |                     |                          |                   |                     |                          |                   |
| 1-4 family                                       | 5,644               | 5,688                    | 584               | 6,241               | 6,562                    | 1,086             |
| <b>Commercial real estate:</b>                   |                     |                          |                   |                     |                          |                   |
| Residential developments                         | 25,197              | 32,563                   | 1,235             | 20,789              | 23,872                   | 2,546             |
| Alternative fuels                                | 0                   | 0                        | 0                 | 0                   | 0                        | 0                 |
| Other  | 4,117               | 4,565                    | 793               | 9,706               | 12,653                   | 1,013             |
| Consumer   | 2,042               | 2,042                    | 576               | 1,205               | 1,205                    | 367               |
| <b>Commercial business:</b>                      |                     |                          |                   |                     |                          |                   |
| Construction/development                         | 119                 | 2,090                    | 65                | 340                 | 2,311                    | 0                 |
| Banking  | 0                   | 0                        | 0                 | 1,149               | 3,248                    | 0                 |
| Other  | 4,225               | 9,229                    | 1,244             | 5,366               | 8,752                    | 1,621             |
|  | \$41,344            | 56,177                   | 4,497             | 44,796              | 58,603                   | 6,633             |

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The following table summarizes average recorded investment and interest income recognized on impaired loans during the three and nine months ended September 30, 2012 and 2011.

|   | For the three months ended<br>September 30, 2012 |                                  | For the nine months ended<br>September 30, 2012 |                                  |
|---|--|----------------------------------|---|----------------------------------|
|   | Average<br>Recorded<br>Investment                | Interest<br>Income<br>Recognized | Average<br>Recorded<br>Investment               | Interest<br>Income<br>Recognized |
| <i>(Dollars in thousands)</i>             |  |                                  |   |                                  |
| Loans with no related allowance recorded: |  |                                  |   |                                  |
| 1-4 family                                | \$ 3,214   | 20                               | 3,312   | 70                               |
| Commercial real estate:                   |  |                                  |   |                                  |
| Residential developments                  | 11,737   | 60                               | 10,752  | 370                              |
| Alternative fuels                         | 0  | 0                                | 0   | 0                                |
| Other                                     | 2,540  | 4                                | 3,177   | 22                               |
| Consumer                                  | 355  | 3                                | 390   | 6                                |
| Commercial business:                      |  |                                  |   |                                  |
| Construction/development                  | 0  | 0                                | 140   | 0                                |
| Banking                                   | 0  | 0                                | 575   | 0                                |
| Other                                     | 1,719  | 2                                | 1,110   | 8                                |
| Loans with an allowance recorded:         |  |                                  |   |                                  |
| 1-4 family                                | 3,491  | 13                               | 3,780   | 52                               |
| Commercial real estate:                   |  |                                  |   |                                  |
| Residential developments                  | 14,521   | 37                               | 14,627  | 111                              |
| Alternative fuels                         | 0  | 0                                | 0   | 0                                |
| Other                                     | 2,577  | 2                                | 4,272   | 4                                |
| Consumer                                  | 1,672  | 32                               | 1,269   | 75                               |
| Commercial business:                      |  |                                  |   |                                  |
| Construction/development                  | 166  | 0                                | 83  | 0                                |
| Banking                                   | 0  | 0                                | 0   | 0                                |
| Other                                     | 2,681  | 9                                | 3,928   | 40                               |
| Total:                                    |  |                                  |   |                                  |
| 1-4 family                                | 6,705  | 33                               | 7,092   | 122                              |
| Commercial real estate:                   |  |                                  |   |                                  |
| Residential developments                  | 26,258   | 97                               | 25,379  | 481                              |
| Alternative fuels                         | 0  | 0                                | 0   | 0                                |
| Other                                     | 5,117  | 6                                | 7,449   | 26                               |
| Consumer                                  | 2,027  | 35                               | 1,659   | 81                               |
| Commercial business:                      |  |                                  |   |                                  |
| Construction/development                  | 166  | 0                                | 223   | 0                                |
| Banking                                   | 0  | 0                                | 575   | 0                                |
| Other                                     | 4,400  | 11                               | 5,038   | 48                               |
|   | \$ 44,673  | 182                              | 47,415  | 758                              |

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|   | For the three months ended<br>September 30, 2011 |                                  | For the nine months ended<br>September 30, 2011 |                                  |
|---|--|----------------------------------|---|----------------------------------|
|   | Average<br>Recorded<br>Investment                | Interest<br>Income<br>Recognized | Average<br>Recorded<br>Investment               | Interest<br>Income<br>Recognized |
| <i>(Dollars in thousands)</i>             |  |                                  |   |                                  |
| Loans with no related allowance recorded: |  |                                  |   |                                  |
| 1-4 family                                | \$ 1,549   | 6                                | 1,351   | 42                               |
| Commercial real estate:                   |  |                                  |   |                                  |
| Residential developments                  | 7,065  | 0                                | 6,624   | 125                              |
| Alternative fuels                         | 2,266  | 0                                | 1,133   | 0                                |
| Other                                     | 676  | 12                               | 531   | 25                               |
| Consumer                                  | 224  | 2                                | 148   | 2                                |
| Commercial business:                      |  |                                  |   |                                  |
| Construction/development                  | 343  | 0                                | 283   | 0                                |
| Banking                                   | 1,562  | 0                                | 781   | 0                                |
| Other                                     | 1,377  | 1                                | 949   | 1                                |
| Loans with an allowance recorded:         |  |                                  |   |                                  |
| 1-4 family                                | 3,467  | 22                               | 4,368   | 90                               |
| Commercial real estate:                   |  |                                  |   |                                  |
| Residential developments                  | 16,820   | 45                               | 18,421  | 264                              |
| Alternative fuels                         | 0  | 0                                | 2,497   | 0                                |
| Other                                     | 6,902  | 12                               | 6,520   | 28                               |
| Consumer                                  | 425  | 4                                | 325   | 20                               |
| Commercial business:                      |  |                                  |   |                                  |
| Construction/development                  | 1,711  | 0                                | 3,053   | 0                                |
| Banking                                   | 338  | 0                                | 4,280   | 0                                |
| Other                                     | 9,654  | 26                               | 10,983  | 90                               |
| Total:                                    |  |                                  |   |                                  |
| 1-4 family                                | 5,016  | 28                               | 5,719   | 132                              |
| Commercial real estate:                   |  |                                  |   |                                  |
| Residential developments                  | 23,885   | 45                               | 25,045  | 389                              |
| Alternative fuels                         | 2,266  | 0                                | 3,630   | 0                                |
| Other                                     | 7,578  | 24                               | 7,051   | 53                               |
| Consumer                                  | 649  | 6                                | 473   | 22                               |
| Commercial business:                      |  |                                  |   |                                  |
| Construction/development                  | 2,054  | 0                                | 3,336   | 0                                |
| Banking                                   | 1,900  | 0                                | 5,061   | 0                                |
| Other                                     | 11,031   | 27                               | 11,932  | 91                               |
|   | \$ 54,379  | 130                              | 62,247  | 687                              |

At September 30, 2012 and December 31, 2011, non-accruing loans totaled \$34.6 million and \$34.0 million, respectively, for which the related allowance for loan losses was \$3.8 million and \$5.2 million, respectively. The decrease in the related allowances is due primarily to the full or partial charge-off of several non-accruing loans. All of the interest income that was recognized for non-accruing loans was recognized using the cash basis method of income recognition. Non-accruing loans for which no specific allowance has been recorded because management determined that the value of the collateral was sufficient to repay the loan, totaled \$13.8 million and \$14.8 million at September 30, 2012 and December 31, 2011, respectively. Non-accrual loans also include certain loans that have had terms modified in a TDR.

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The non-accrual loans at September 30, 2012 and December 31, 2011 are summarized as follows:

| <i>(Dollars in thousands)</i> | September 30, 2012 | December 31, 2011 |
|-------------------------------|--------------------|-------------------|
| 1-4 family                    | \$ 2,992           | \$ 4,435          |
| Commercial real estate:       |                    |                   |
| Residential developments      | 25,124             | 13,412            |
| Alternative fuels             | 0                  | 0                 |
| Other                         | 2,583              | 9,246             |
| Consumer                      | 317                | 699               |
| Commercial business:          |                    |                   |
| Construction/development      | 119                | 340               |
| Banking                       | 0                  | 1,149             |
| Other                         | 3,447              | 4,712             |
|                               | <b>\$ 34,582</b>   | <b>\$ 33,993</b>  |

Included in loans above 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 borrowers' financial difficulties, grants a concession compared to the original terms and conditions of the loan, the modified loan is considered a troubled debt restructuring (TDR).

During the third quarter of 2011, the Company adopted Accounting Standards Update (ASU) 2011-02, *A Creditor's Determination of Whether a Restructuring is a Troubled Debt Restructuring (Topic 310)*, which modified guidance for identifying restructurings of receivables that constitute a TDR. At September 30, 2012 and December 31, 2011, there were loans included in loans receivable, net, with terms that had been modified in a troubled debt restructuring totaling \$34.1 million and \$29.2 million, respectively. For the loans that were modified in the third quarter of 2012, \$0.3 million were classified but performing and \$2.2 million were non-performing at September 30, 2012.

The following table summarizes troubled debt restructurings at September 30, 2012 and December 31, 2011:

| <i>(Dollars in thousands)</i> | September 30, 2012 |               |               | December 31, 2011 |               |               |
|-------------------------------|--------------------|---------------|---------------|-------------------|---------------|---------------|
|                               | Accrual            | Non-Accrual   | Total         | Accrual           | Non-Accrual   | Total         |
| 1-4 Family                    | \$ 2,652           | 1,371         | 4,023         | 1,806             | 1,999         | 3,805         |
| Commercial real estate        | 1,607              | 23,449        | 25,056        | 7,837             | 12,221        | 20,058        |
| Consumer                      | 1,725              | 0             | 1,725         | 507               | 71            | 578           |
| Commercial business           | 778                | 2,554         | 3,332         | 653               | 4,110         | 4,763         |
|                               | <b>\$ 6,762</b>    | <b>27,374</b> | <b>34,136</b> | <b>10,803</b>     | <b>18,401</b> | <b>29,204</b> |

There were no material commitments to lend additional funds to customers whose loans were restructured or classified as nonaccrual at September 30, 2012 or December 31, 2011.

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 TDRs 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 the entire 12 month period. All loans classified as TDRs are considered to be impaired.

When a loan is modified as a TDR, there may be a direct, material impact on the loans within the balance sheet, as principal balances may be partially forgiven. The financial effects of TDRs are presented in the following table and represent the difference between the outstanding recorded balance pre-modification and post-modification, for the three month and nine month periods ending September 30, 2012 and 2011.

|                               | Three Months Ended<br>September 30, 2012 |   |  | Nine Months Ended<br>September 30, 2012 |   |  |
|-------------------------------|--|---|--|---|---|--|
|                               | Number of<br>Contracts                   | Pre-<br>modification<br>Outstanding<br>Recorded<br>Investment | Post-modification<br>Outstanding<br>Recorded<br>Investment | Number of<br>Contracts                  | Pre-<br>modification<br>Outstanding<br>Recorded<br>Investment | Post-modification<br>Outstanding<br>Recorded<br>Investment |
| <i>(Dollars in thousands)</i> |  |   |  |   |   |  |
| Troubled debt restructurings: |  |   |  |   |   |  |
| 1-4 family                    | 4  | \$ 452  | 439  | 31                                      | \$ 3,666  | 3,643  |
| Commercial real estate:       |  |   |  |   |   |  |
| Residential developments      | 3  | 2,565   | 1,702  | 10                                      | 14,044  | 11,524   |
| Alternative fuels             | 0  | 0   | 0  | 0                                       | 0   | 0  |
| Other                         | 0  | 0   | 0  | 6                                       | 2,814   | 2,587  |
| Consumer                      | 4  | 183   | 205  | 15                                      | 1,413   | 1,435  |
| Commercial business:          |  |   |  |   |   |  |
| Construction/development      | 0  | 0   | 0  | 0                                       | 0   | 0  |
| Banking                       | 0  | 0   | 0  | 0                                       | 0   | 0  |
| Other                         | 2  | 211   | 211  | 5                                       | 551   | 551  |
| Total                         | 13                                       | \$ 3,411  | 2,557  | 67                                      | \$ 22,488   | 19,740   |

|                               | Three Months Ended<br>September 30, 2011 |   |  | Nine Months Ended<br>September 30, 2011 |   |  |
|-------------------------------|--|---|--|---|---|--|
|                               | Number of<br>Contracts                   | Pre-<br>modification<br>Outstanding<br>Recorded<br>Investment | Post-modification<br>Outstanding<br>Recorded<br>Investment | Number of<br>Contracts                  | Pre-<br>modification<br>Outstanding<br>Recorded<br>Investment | Post-modification<br>Outstanding<br>Recorded<br>Investment |
| <i>(Dollars in thousands)</i> |  |   |  |   |   |  |
| Troubled debt restructurings: |  |   |  |   |   |  |
| 1-4 family                    | 5  | \$ 1,234  | 1,234  | 13                                      | \$ 2,783  | 2,783  |
| Commercial real estate:       |  |   |  |   |   |  |
| Residential developments      | 2  | 2,349   | 2,349  | 9                                       | 7,790   | 7,790  |
| Alternative fuels             | 0  | 0   | 0  | 0                                       | 0   | 0  |
| Other                         | 0  | 0   | 0  | 8                                       | 7,394   | 6,394  |
| Consumer                      | 3  | 57  | 24   | 11                                      | 261   | 228  |
| Commercial business:          |  |   |  |   |   |  |
| Construction/development      | 0  | 0   | 0  | 3                                       | 2,360   | 1,095  |
| Banking                       | 0  | 0   | 0  | 0                                       | 0   | 0  |
| Other                         | 5  | 7,047   | 5,905  | 20                                      | 9,641   | 8,299  |
| Total                         | 15                                       | \$ 10,687   | 9,512  | 64                                      | \$ 30,229   | 26,589   |



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Loans that were restructured within the 12 months preceding September 30, 2012 and 2011 and defaulted during the three and nine months ended September 30, 2012 and 2011 are presented in the table below.

| <i>(Dollars in thousands)</i>                                    | Three Months Ended<br>September 30, 2012 |                                    | Nine Months Ended<br>September 30, 2012 |                                    |
|--|--|------------------------------------|---|------------------------------------|
|  | Number of<br>Contracts                   | Outstanding Recorded<br>Investment | Number of<br>Contracts                  | Outstanding Recorded<br>Investment |
| <b>Troubled debt restructurings that subsequently defaulted:</b> |  |                                    |   |                                    |
| 1-4 family   | 0  | \$ 0                               | 2                                       | \$ 940                             |
| <b>Commercial real estate:</b>                                   |  |                                    |   |                                    |
| Residential developments   | 0  | 0                                  | 0                                       | 0                                  |
| Alternative fuels  | 0  | 0                                  | 0                                       | 0                                  |
| Other  | 0  | 0                                  | 2                                       | 159                                |
| Consumer   | 1  | 71                                 | 1                                       | 71                                 |
| <b>Commercial business:</b>                                      |  |                                    |   |                                    |
| Construction/development   | 0  | 0                                  | 0                                       | 0                                  |
| Banking  | 0  | 0                                  | 0                                       | 0                                  |
| Other  | 2  | 227                                | 5                                       | 3,004                              |
| <b>Total</b>   | <b>3</b>                                 | <b>\$ 298</b>                      | <b>10</b>                               | <b>\$ 4,174</b>                    |

| <i>(Dollars in thousands)</i>                                    | Three Months Ended<br>September 30, 2011 |                                    | Nine Months Ended<br>September 30, 2011 |                                    |
|--|--|------------------------------------|---|------------------------------------|
|  | Number of<br>Contracts                   | Outstanding Recorded<br>Investment | Number of<br>Contracts                  | Outstanding Recorded<br>Investment |
| <b>Troubled debt restructurings that subsequently defaulted:</b> |  |                                    |   |                                    |
| 1-4 family   | 1  | \$ 250                             | 1                                       | \$ 250                             |
| <b>Commercial real estate:</b>                                   |  |                                    |   |                                    |
| Residential developments   | 5  | 4,501                              | 5                                       | 4,501                              |
| Alternative fuels  | 0  | 0                                  | 0                                       | 0                                  |
| Other  | 3  | 4,464                              | 3                                       | 4,464                              |
| Consumer   | 0  | 0                                  | 0                                       | 0                                  |
| <b>Commercial business:</b>                                      |  |                                    |   |                                    |
| Construction/development   | 0  | 0                                  | 0                                       | 0                                  |
| Banking  | 0  | 0                                  | 0                                       | 0                                  |
| Other  | 1  | 447                                | 3                                       | 506                                |
| <b>Total</b>   | <b>10</b>                                | <b>\$ 9,662</b>                    | <b>12</b>                               | <b>\$ 9,721</b>                    |

The Company considers a loan to have defaulted when it becomes 90 or more days past due under the modified terms, when it is placed in non-accrual status, when it becomes other real estate owned, or when it becomes non-compliant with some other material requirement of the modification agreement.

Loans that were non-accrual prior to modification remain 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 as long as no principal has been charged off as part of the restructuring. Loans that have been partially charged off remain nonaccrual until the loan is paid off. 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.

TDR s are reviewed for impairment following the same methodology as other impaired loans. For loans that are collateral dependent, the value of the collateral is reviewed and additional reserves may be added as needed. Loans that are not collateral dependent may have additional reserves established if deemed necessary. The allowance for loan losses on TDR s was \$3.0 million, or 14.9%, of the total \$20.5 million in loan loss reserves at September 30, 2012 and \$3.5 million, or 14.6%, of the total \$23.9 million in loan loss reserves at December 31, 2011.



**(11) Investment in Mortgage Servicing Rights**

A summary of mortgage servicing rights activity is as follows:

| <i>(Dollars in thousands)</i>           | Nine Months ended<br>September 30, 2012 | Twelve Months ended<br>December 31,<br>2011 | Nine Months ended<br>September<br>30, 2011 |
|---|---|---|--|
| <b>Mortgage servicing rights:</b>       |   |   |  |
| Balance, beginning of period            | \$ 1,485                                | 1,586                                       | 1,586                                      |
| Originations                            | 643                                     | 461   | 218  |
| Amortization                            | (548)                                   | (562)                                       | (357)                                      |
| <b>Balance, end of period</b>           | <b>\$ 1,580</b>                         | <b>1,485</b>                                | <b>1,447</b>                               |
| Fair value of mortgage servicing rights | \$ 2,047                                | 1,878                                       | 1,860                                      |

All of the loans being serviced are single family loans serviced for the Federal National Mortgage Association (FNMA) under the mortgage-backed security program or the individual loan sale program. The following is a summary of the risk characteristics of the loans being serviced at September 30, 2012.

| <i>(Dollars in thousands)</i>    | Loan Principal<br>Balance | Weighted<br>Average<br>Interest Rate | Weighted<br>Average<br>Remaining Term | Number of<br>Loans |
|----------------------------------|---------------------------|--------------------------------------|---------------------------------------|--------------------|
| Original term 30 year fixed rate | \$ 194,559                | 4.77%                                | 299                                   | 1,701              |
| Original term 15 year fixed rate | 110,404                   | 3.86%                                | 141                                   | 1,378              |
| Adjustable rate                  | 323                       | 3.51%                                | 305                                   | 6                  |

The gross carrying amount of mortgage servicing rights and the associated accumulated amortization at September 30, 2012 is presented in the table below. Amortization expense for mortgage servicing rights was \$548,000 and \$357,000 respectively, for the nine-month periods ended September 30, 2012 and 2011.

| <i>(Dollars in thousands)</i>    | Gross Carrying<br>Amount | Accumulated<br>Amortization | Unamortized<br>Balance |
|----------------------------------|--------------------------|-----------------------------|------------------------|
| <b>Mortgage servicing rights</b> | <b>\$ 2,244</b>          | <b>(664)</b>                | <b>1,580</b>           |

The following table indicates the estimated future amortization expense for mortgage servicing rights:

| <i>(Dollars in thousands)</i>  | Mortgage<br>Servicing Rights |
|--------------------------------|------------------------------|
| <b>Year ended December 31,</b> |                              |
| 2012                           | \$ 367                       |
| 2013                           | 353                          |
| 2014                           | 323                          |
| 2015                           | 269                          |
| 2016                           | 162                          |
| 2017 and beyond                | 106                          |

Projections of amortization are based on existing asset balances and the existing interest rate environment as of September 30, 2012. The Company's actual experiences may be significantly different depending upon changes in mortgage interest rates and other market conditions.



**(12) Earnings (Loss) per Common Share**

The following table reconciles the weighted average shares outstanding and the earnings (loss) available to common shareholders used for basic and diluted earnings (loss) per share:

| <i>(Dollars in thousands, except per share data)</i>   | Three Months Ended September 30, |             | Nine Months Ended September 30, |             |
|--|----------------------------------|-------------|---------------------------------|-------------|
|  | 2012                             | 2011        | 2012                            | 2011        |
| Weighted average number of common shares outstanding used in basic loss per common share calculation | 3,957                            | 3,865       | 3,936                           | 3,841       |
| Net dilutive effect of:  |                                  |             |                                 |             |
| Restricted stock awards  | 79                               | 0           | 91                              | 0           |
| <br>Weighted average number of shares outstanding adjusted for effect of dilutive securities         | <br>4,036                        | <br>3,865   | <br>4,027                       | <br>3,841   |
| <br>Income (loss) available to common shareholders   | <br>\$ 170                       | <br>(2,511) | <br>2,444                       | <br>(5,291) |
| Basic earnings (loss) per common share   | \$ 0.04                          | (0.65)      | 0.62                            | (1.38)      |
| Diluted earnings (loss) per common share   | \$ 0.04                          | (0.65)      | 0.61                            | (1.38)      |

For the three and nine month periods ended September 30, 2011, there were 110,081 and 121,531 common share equivalents outstanding, respectively, that are not included in the calculation of diluted earnings per share as they are anti-dilutive because the Company had a net loss for the period.

**(13) Regulatory Capital and Regulatory Oversight**

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

The Bank entered into a written Supervisory Agreement with its primary regulator, the OTS, effective February 22, 2011 that primarily relates to the Bank's financial performance and credit quality issues. This agreement replaced the prior memorandum of understanding that the Bank entered into with the OTS on December 9, 2009. In accordance with the agreement, the Bank submitted a two year business plan in May of 2011 that the OCC (as defined below and as successor to the OTS) accepted with the expectation that the Bank would be in adherence with the OCC's Notification of Establishment of Higher Minimum Capital Ratios, dated August 8, 2011, also known as an individual minimum capital requirement or IMCR, which required the Bank to establish and maintain a minimum core capital ratio of 8.50% by December 31, 2011, as discussed more fully below. As required by the Supervisory Agreement, the Bank submitted an updated two year capital plan in January of 2012 that the OCC may make comments upon, and require revisions to. The Bank must operate within the parameters of the final business plan and is required to monitor and submit periodic reports on its compliance with the plan. The Bank also submitted a problem asset reduction plan that the OCC has accepted. The Bank must operate within the parameters of the final problem asset plan and is required to monitor and submit periodic reports on its compliance with the plan. The Bank has also revised its loan modification policies and its program for identifying, monitoring and controlling risk associated with concentrations of credit, and improved the documentation relating to the allowance for loan and lease losses as required by the agreement. In addition, without the consent of the OCC, the Bank may not declare or pay any cash dividends, increase its total assets during any quarter in excess of the amount of the net interest credited on deposit liabilities during the prior quarter, enter into any new contractual arrangement or renew or extend any existing arrangement related to compensation or benefits with any directors or officer, make any golden parachute payments, or enter into any significant contracts with a third party service provider. The Bank believes it was in compliance with all requirements of its Supervisory Agreement at September 30, 2012.

The Company also entered into a written Supervisory Agreement with the OTS effective February 22, 2011. This agreement replaced the prior memorandum of understanding that the Company entered into with the OTS on December 9, 2009. As required by the Supervisory Agreement, the Company submitted an updated two year capital plan in January of 2012 that the Federal Reserve Board (as successor to the OTS) may make comments upon, and to which it may require revisions. The Company must operate within the parameters of the final capital plan and is required to monitor and submit periodic reports on its compliance with the plan. In addition, without the consent of



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the Federal Reserve Board, the Company may not incur or issue any debt, guarantee the debt of any entity, declare or pay any cash dividends or repurchase any of the Company's capital stock, enter into any new contractual arrangement or renew or extend any existing arrangement related to compensation or benefits with any directors or officer, or make any golden parachute payments. The Company believes it was in compliance with all requirements of its Supervisory Agreement at September 30, 2012.

References to the OTS shall mean, with respect to the Company, beginning July 21, 2011, the Federal Reserve Board (FRB) and mean, with respect to the Bank, beginning July 21, 2011, the Office of the Comptroller of the Currency (OCC). On July 21, 2011, the OTS was integrated into the OCC and the primary banking regulator for the Company became the FRB.

Quantitative measures established by regulations to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the following table) of Tier I (Core) capital, and risk-based capital (as defined in the regulations) to total assets (as defined in the regulations).

The Bank's tangible assets were \$643.2 million and \$789.0 million, adjusted total assets were \$643.1 million and \$789.0 million, and its risk-weighted assets were \$461.1 million and \$586.0 million at September 30, 2012 and December 31, 2011, respectively. The following table presents the Bank's capital amounts and ratios at September 30, 2012 and December 31, 2011 for actual capital, required capital and excess capital, including ratios in order to qualify as being well capitalized under the prompt corrective actions regulations.

| <i>(Dollars in thousands)</i>                                 | Actual    |                                  | Required to be Adequately Capitalized |                                  | Excess Capital |                                  | To Be Well Capitalized Under Prompt Corrective Actions Provisions |                                  |
|---|-----------|----------------------------------|---------------------------------------|----------------------------------|----------------|----------------------------------|---|----------------------------------|
|   | Amount    | Percent of Assets <sup>(1)</sup> | Amount                                | Percent of Assets <sup>(1)</sup> | Amount         | Percent of Assets <sup>(1)</sup> | Amount  | Percent of Assets <sup>(1)</sup> |
| September 30, 2012  |           |                                  |                                       |                                  |                |                                  |   |                                  |
| Bank stockholder's equity                                     | \$ 61,524 |                                  |                                       |                                  |                |                                  |   |                                  |
| Less:   |           |                                  |                                       |                                  |                |                                  |   |                                  |
| Net unrealized gains on certain securities available for sale | (122)     |                                  |                                       |                                  |                |                                  |   |                                  |
| Tier I or core capital  | 61,402    |                                  |                                       |                                  |                |                                  |   |                                  |
| Tier I capital to adjusted total assets                       |           | 9.55%                            | \$ 25,722                             | 4.00%                            | \$ 35,680      | 5.55%                            | \$ 32,153   | 5.00%                            |
| Tier I capital to risk-weighted assets                        |           | 13.32%                           | \$ 18,443                             | 4.00%                            | \$ 42,959      | 9.32%                            | \$ 27,665   | 6.00%                            |
| Plus:   |           |                                  |                                       |                                  |                |                                  |   |                                  |
| Allowable allowance for loan losses                           | 5,945     |                                  |                                       |                                  |                |                                  |   |                                  |
| Risk-based capital  | \$ 67,347 |                                  | \$ 36,886                             |                                  | \$ 30,461      |                                  | \$ 46,108   |                                  |
| Risk-based capital to risk-weighted assets                    |           | 14.61%                           |                                       | 8.00%                            |                | 6.61%                            |   | 10.00%                           |

(1) Based upon the Bank's adjusted total assets for the purpose of the tangible and core capital ratios and risk-weighted assets for the purpose of the risk-based capital ratio.

| <i>(Dollars in thousands)</i> | Actual    |                                  | Required to be Adequately Capitalized |                                  | Excess Capital |                                  | To Be Well Capitalized Under Prompt Corrective Actions Provisions |                                  |
|-------------------------------|-----------|----------------------------------|---------------------------------------|----------------------------------|----------------|----------------------------------|---|----------------------------------|
|                               | Amount    | Percent of Assets <sup>(1)</sup> | Amount                                | Percent of Assets <sup>(1)</sup> | Amount         | Percent of Assets <sup>(1)</sup> | Amount  | Percent of Assets <sup>(1)</sup> |
| December 31, 2011             |           |                                  |                                       |                                  |                |                                  |   |                                  |
| Bank stockholder's equity     | \$ 57,454 |                                  |                                       |                                  |                |                                  |   |                                  |
| Less:                         |           |                                  |                                       |                                  |                |                                  |   |                                  |
|                               | (1,140)   |                                  |                                       |                                  |                |                                  |   |                                  |

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Net unrealized gains on certain securities available for sale

|  |           |        |           |       |           |       |           |        |
|--|-----------|--------|-----------|-------|-----------|-------|-----------|--------|
| Tier I or core capital                     | 56,314    |        |           |       |           |       |           |        |
| Tier I capital to adjusted total assets    |           | 7.14%  | \$ 31,560 | 4.00% | \$ 24,754 | 3.14% | \$ 39,450 | 5.00%  |
| Tier I capital to risk-weighted assets     |           | 9.61%  | \$ 23,441 | 4.00% | \$ 32,873 | 5.61% | \$ 35,162 | 6.00%  |
| Plus:                                      |           |        |           |       |           |       |           |        |
| Allowable allowance for loan losses        | 7,325     |        |           |       |           |       |           |        |
| Risk-based capital                         | \$ 63,639 |        | \$ 46,883 |       | \$ 16,756 |       | \$ 58,603 |        |
| Risk-based capital to risk-weighted assets |           | 10.86% |           | 8.00% |           | 2.86% |           | 10.00% |

(1) Based upon the Bank's adjusted total assets for the purpose of the tangible and core capital ratios and risk-weighted assets for the purpose of the risk-based capital ratio.



The OCC established an IMCR for the Bank. An IMCR requires a bank to establish and maintain levels of capital greater than those generally required for a bank to be classified as well-capitalized. Effective December 31, 2011, the Bank was required to establish, and subsequently maintain, core capital at least equal to 8.50% of adjusted total assets, which was in excess of the Bank's 7.14% core capital to adjusted total assets ratio at December 31, 2011. In February 2012, the Bank received a Notice of Failure to Maintain Minimum Capital Ratios from the OCC arising out of its failure to establish and maintain its IMCR of 8.50% core capital to adjusted total assets at December 31, 2011. Pursuant to the notice, the OCC required the Bank to submit by April 30, 2012 a further written capital plan of how it intended to achieve and maintain its IMCR, and a contingency plan in the event the IMCR was not achieved through the Bank's primary plan. In April 2012, the Bank submitted the required revised capital and contingency plan to the OCC which they may make comments upon and require revisions. Because of the improved financial results and the decrease in assets experienced during the first nine months of 2012, the Bank's core capital ratio improved to 8.50% at March 31, 2012, 9.04% at June 30, 2012, and 9.55% at September 30, 2012.

The Bank's failure to comply with the terms of the IMCR at December 31, 2011 was, and its failure to continue to comply in the future can be, deemed an unsafe and unsound banking practice and could subject it to further limits on growth and such legal actions or sanctions as the OCC considers appropriate. There can be no assurance that the Bank will continue to maintain compliance with the IMCR in the future. Possible sanctions include among others (i) the imposition of one or more cease and desist orders requiring corrective action, which are enforceable directives that may address any aspect of the Company or Bank management, operations or capital, including requirements to change management, raise equity capital, dispose of assets or effect a change of control; (ii) civil money penalties; and (iii) downgrades in the capital adequacy status of the Company and the Bank. These regulatory actions may significantly restrict the ability of the Company and the Bank to take operating and strategic actions that may be in the best interests of stockholders or compel the Company and the Bank to take operating and strategic actions that are not potentially in the best interests of stockholders.

Management believes that, as of September 30, 2012, the Bank's capital ratios were in excess of those quantitative capital ratio standards set forth under the prompt corrective action regulations described above. The failure of the Bank to satisfy the IMCR at any time does not by itself affect the Bank's status as well-capitalized within the meaning of these prompt corrective action regulations. However, there can be no assurance that the Bank will continue to maintain such status in the future. The OCC has extensive discretion in its supervisory and enforcement activities, and can adjust the requirement to be well-capitalized in the future.

In order to improve its capital ratios and maintain compliance with its IMCR, the Bank is, among other things, working to improve its financial results, reduce non-performing assets, and decrease the asset size of the Bank. In March 2012, the Bank also sold substantially all of the assets and liabilities associated with its Toledo, Iowa branch. If capital conditions were to deteriorate, the Bank may also determine it to be necessary or prudent to dispose of other non-strategic assets. These actions may result in changes in the Bank's assets, liabilities and earnings, some of which may be material, during the period in which the action is taken or is consummated or over a longer period of time. Further, the Company may need, or be required by supervising banking regulators, to raise additional capital of which there can be no assurance that, if raised, it would be on terms favorable to the Company. If the Company raises capital through the issuance of additional shares of common stock or other equity securities, it would dilute the ownership interests of existing stockholders and, given our current common stock trading price, would be expected to dilute the per share book value of the Company's common stock and could result in a change of control of the Company and the Bank.

The capital requirements of the Company and the Bank may be affected in the future by recently proposed regulatory changes. In June 2012, the Federal Reserve Board, the FDIC and the OCC jointly proposed new capital rules (Proposed Rules) that among other things, if adopted, would require the Company and the Bank to (1) establish a new minimum common equity Tier 1 ratio of 4.5% of risk-weighted assets; (2) raise the minimum Tier 1 capital ratio from 4.0% to 6.0% of risk-weighted assets; (3) maintain the minimum total capital ratio of 8.0% of risk-weighted assets; and (4) maintain a minimum Tier 1 capital to adjusted total assets of 4.0%. These changes would be phased in incrementally beginning January 1, 2013 to provide time for banking organizations to meet the new capital standards, with full implementation to occur by January 1, 2015.

In addition, the Proposed Rules would add a requirement for a minimum common equity Tier 1 capital conservation buffer of 2.5% of risk-weighted assets (Conservation Buffer) to be applied to the common equity Tier 1 capital ratio, the Tier 1 capital ratio and the total capital ratio. Therefore, application of the Conservation Buffer would result in (1) a common equity Tier 1 ratio of 7% of risk-weighted assets; (2) a Tier 1 capital ratio of 8.5% of risk-weighted assets; and (3) a total capital ratio of 10.0% of risk-weighted assets. Failure to maintain the Conservation Buffer would result in restrictions on capital distributions and certain discretionary cash bonus payments to executive officers. The required minimum Conservation Buffer would be phased in incrementally beginning January 1, 2016. An institution would be subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital falls below the Conservation Buffer. These limitations would establish a maximum percentage of eligible retained income that could be utilized for such actions.

The Proposed Rules would also revise the definition of capital to improve the ability of regulatory capital instruments to absorb losses and revise the rules for calculating risk-weighted assets to enhance risk sensitivity, which will exclude certain non-qualifying capital instruments, including cumulative preferred stock (other than preferred securities issued in connection with the TARP Capital Purchase Program) and trust preferred securities, as a component of Tier 1 capital. The Proposed Rules set forth certain changes for the calculation of risk-weighted assets, which the Company and the Bank would be required to utilize beginning January 1, 2015. The Proposed Rules utilize an increased number of credit risk exposure categories and risk weights, and also addresses: (1) a proposed alternative standard of creditworthiness consistent with Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act; (2) revisions to recognition of credit risk mitigation; (3) rules for risk weighting of equity exposures and past due loans; and (4) revised capital treatment for derivatives and repo-style transactions.

The Proposed Rules also revise certain of the prompt corrective action regulations described above. These revisions would take effect January 1, 2015. Under the prompt corrective action regulations, the Bank would be required to meet the following increased capital level requirements in order to qualify as well capitalized: (1) a new common equity Tier 1 capital ratio of 6.5% of risk-weighted assets; (2) a Tier 1 capital ratio of 8% (increased from 6%) of risk-weighted assets; (3) a total capital ratio of 10% (unchanged from current rules) of risk-weighted assets; and (4) a Tier 1 capital to adjusted total assets ratio of 5% (unchanged from current rules). The IMCR requirement discussed above is currently higher than the Tier 1 capital to adjusted total assets of 5.0% that would be required by the Proposed Rules.

The Company and the Bank are reviewing the potential impact of the Proposed Rules on its future capital requirements.

#### ***(14) Commitments and Contingencies***

The Bank issued standby letters of credit which guarantee the performance of customers to third parties. The standby letters of credit issued and available at September 30, 2012 were approximately \$1.7 million, expire over the next two years, and are collateralized primarily with commercial business assets. Since the conditions under which the Bank is required to fund the standby letters of credit may not materialize, the cash requirements are expected to be less than the total outstanding commitments.

#### ***(15) Business Segments***

The Bank has been identified as a reportable operating segment in accordance with the provisions of ASC 280. SFC and HMN did not meet the quantitative thresholds for determining reportable segments and therefore are included in the Other category.

The Company evaluates performance and allocates resources based on the segment's net income, return on average assets and equity. Each corporation is managed separately with its own officers and board of directors, some of whom may overlap between the corporations.

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The following table sets forth certain information about the reconciliation of reported profit or loss and assets for each of the Company's reportable segments.

| <i>(Dollars in thousands)</i>                              | Home Federal<br>Savings<br>Bank | Other   | Eliminations | Consolidated Total |
|--|---------------------------------|---------|--------------|--------------------|
| <b>At or for the nine months ended September 30, 2012:</b> |                                 |         |              |                    |
| Interest income - external customers                       | \$ 23,778                       | 0       | 0            | 23,778             |
| Non-interest income - external customers                   | 6,616                           | 0       | 0            | 6,616              |
| Intersegment interest income                               | 0                               | 2       | (2)          | 0                  |
| Intersegment non-interest income                           | 139                             | 4,413   | (4,552)      | 0                  |
| Interest expense   | 5,628                           | 0       | (2)          | 5,626              |
| Amortization of mortgage servicing rights, net             | 548                             | 0       | 0            | 548                |
| Other non-interest expense                                 | 17,394                          | 585     | (139)        | 17,840             |
| Net income   | 4,419                           | 3,830   | (4,413)      | 3,836              |
| Total assets   | 643,624                         | 62,721  | (62,622)     | 643,723            |
| <b>At or for the nine months ended September 30, 2011:</b> |                                 |         |              |                    |
| Interest income - external customers                       | \$ 30,331                       | 0       | 0            | 30,331             |
| Non-interest income - external customers                   | 4,901                           | 0       | 0            | 4,901              |
| Loss on limited partnerships                               | (7)                             | 0       | 0            | (7)                |
| Intersegment interest income                               | 0                               | 3       | (3)          | 0                  |
| Intersegment non-interest income                           | 140                             | (3,164) | 3,024        | 0                  |
| Interest expense   | 8,806                           | 0       | (3)          | 8,803              |
| Amortization of mortgage servicing rights, net             | 357                             | 0       | 0            | 357                |
| Other non-interest expense                                 | 19,689                          | 775     | (139)        | 20,325             |
| Net loss   | (3,158)                         | (3,935) | 3,164        | (3,929)            |
| Total assets   | 818,315                         | 66,706  | (66,637)     | 818,384            |
| <b>At or for the quarter ended September 30, 2012:</b>     |                                 |         |              |                    |
| Interest income - external customers                       | \$ 7,551                        | 0       | 0            | 7,551              |
| Non-interest income - external customers                   | 2,116                           | 0       | 0            | 2,116              |
| Intersegment non-interest income                           | 46                              | 831     | (877)        | 0                  |
| Interest expense   | 1,659                           | 0       | 0            | 1,659              |
| Amortization of mortgage servicing rights, net             | 200                             | 0       | 0            | 200                |
| Other non-interest expense                                 | 5,437                           | 196     | (46)         | 5,587              |
| Net income   | 833                             | 635     | (831)        | 637                |
| Total assets   | 643,624                         | 62,721  | (62,622)     | 643,723            |
| <b>At or for the quarter ended September 30, 2011:</b>     |                                 |         |              |                    |
| Interest income - external customers                       | \$ 9,572                        | 0       | 0            | 9,572              |
| Non-interest income - external customers                   | 1,521                           | 0       | 0            | 1,521              |
| Loss on limited partnerships                               | (2)                             | 0       | 0            | (2)                |
| Intersegment interest income                               | 0                               | 1       | (1)          | 0                  |
| Intersegment non-interest income                           | 53                              | 488     | (541)        | 0                  |
| Interest expense   | 2,489                           | 0       | (1)          | 2,488              |
| Amortization of mortgage servicing rights, net             | 143                             | 0       | 0            | 143                |
| Other non-interest expense                                 | 6,121                           | 186     | (52)         | 6,255              |
| Net loss   | (1,870)                         | (2,057) | 1,872        | (2,055)            |
| Total assets   | 818,315                         | 66,706  | (66,637)     | 818,384            |

**Item 2:**

**HMN FINANCIAL, INC.**

**MANAGEMENT'S DISCUSSION AND ANALYSIS**

**OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

***Forward-looking Information***

This quarterly report and other reports filed by the Company with the Securities and Exchange Commission may contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995.

These statements are often identified by such forward-looking terminology as expect, intent, look, believe, anticipate, estimate, project, may, will, would, could, should, trend, target, and goal or similar statements or variations of such terms and include, but are not limited to, relating to increasing our core deposit relationships, reducing non-performing assets, reducing expense and generating improved financial results; the adequacy and amount of available liquidity and capital resources to the Bank; the Company's liquidity and capital requirements; our expectations for core capital and our strategies and potential strategies for improvement thereof; changes in the size of the Bank's loan portfolio; the recovery of the valuation allowance on deferred tax assets; the amount and mix of the Bank's non-performing assets and the appropriateness of the allowance therefor; future losses on non-performing assets; the amount of interest-earning assets; the amount and mix of brokered and other deposits (including the Company's ability to renew brokered deposits); the availability of alternate funding sources; the payment of dividends; the future outlook for the Company; the amount of deposits that will be withdrawn from checking and money market accounts and how the withdrawn deposits will be replaced; the projected changes in net interest income based on rate shocks; the range that interest rates may fluctuate over the next twelve months; the net market risk of interest rate shocks; the future outlook for the issuer trust preferred securities held by the Bank; and the Bank's compliance with regulatory standards generally (including the Bank's status as well-capitalized), and supervisory agreements, individual minimum capital requirements, the recently proposed regulatory capital rules that were jointly issued by the Federal Reserve Board, the FDIC, and the OCC in June 2012 (Proposed Rules), or other supervisory directives or requirements to which the Company or the Bank are or may become expressly subject, specifically, and possible responses of the OCC and FRB and the Bank and the Company to any failure to comply with any such regulatory standard, agreement or requirement. A number of factors could cause actual results to differ materially from the Company's assumptions and expectations. These include but are not limited to the adequacy and marketability of real estate and other collateral securing loans to borrowers; federal and state regulation and enforcement, including restrictions set forth in the supervisory agreements between each of the Company and Bank and the OCC and FRB; possible legislative and regulatory changes, including changes in the degree and manner of regulatory supervision, the ability of the Company and the Bank to establish and adhere to plans and policies relating to, among other things, capital, business, non-performing assets, loan modifications, documentation of loan loss allowance and concentrations of credit that are satisfactory to the OCC and FRB, as applicable, in accordance with the terms of the Company and Bank supervisory agreements and to otherwise manage the operations of the Company and the Bank to ensure compliance with other requirements set forth in the supervisory agreements; the ability of the Company and the Bank to obtain required consents from the OCC and FRB, as applicable, under the supervisory agreements or other directives; the ability of the Bank to comply with its individual minimum capital requirement, the Proposed Rules, and other applicable regulatory capital requirements; enforcement activity of the OCC and FRB in the event of our non-compliance with any applicable regulatory standard, agreement or requirement; adverse economic, business and competitive developments such as shrinking interest margins, reduced collateral values, deposit outflows, changes in credit or other risks posed by the Company's loan and investment portfolios, changes in costs associated with alternate funding sources, including changes in collateral advance rates and policies of the Federal Home Loan Bank, technological, computer-related or operational difficulties, results of litigation, and reduced demand for financial services and loan products; changes in accounting policies and guidelines, or monetary and fiscal policies of the federal government or tax laws; international economic developments; the Company's access to and adverse changes in securities markets; the market for credit related assets; or other significant uncertainties. Additional factors that may cause actual results to differ from the Company's assumptions and expectations include those set forth in the Company's most recent filing on Form 10-K with the Securities and Exchange Commission and the Company's subsequently filed Quarterly Reports on Form 10-Q. All forward-looking statements are qualified by, and should be considered in conjunction with, such cautionary statements. For additional discussion of the risks and uncertainties applicable to the Company, see the Risk Factors sections of the Company's Annual Report on Form 10-K for the year ended December 31, 2011 and Part II, Item 1A of its Quarterly Reports on Form 10-Q.

***General***

The earnings of the Company are primarily dependent on the Bank's net interest income, which is the difference between interest earned on loans and investments, and the interest paid on interest-bearing liabilities such as deposits, Federal Home Loan Bank (FHLB) advances, and Federal Reserve Bank (FRB) borrowings. The difference between



the average rate of interest earned on assets and the average rate paid on liabilities is the interest rate spread. Net interest income is produced when interest-earning assets equal or exceed interest-bearing liabilities and there is a positive interest rate spread. Net interest income and net interest rate spread are affected by changes in interest rates, the volume and mix of interest-earning assets and interest-bearing liabilities, and the level of non-performing assets. The Company's net income is also affected by the generation of non-interest income, which consists primarily of gains or losses from the sale of securities, gains from the sale of loans, fees for servicing mortgage loans, and the generation of fees and service charges on deposit accounts. The Bank incurs expenses in addition to interest expense in the form of salaries and benefits, occupancy expenses, provisions for loan losses, and amortization of mortgage servicing assets. The earnings of financial institutions, such as the Bank, are also significantly affected by prevailing economic and competitive conditions, particularly changes in interest rates, government monetary and fiscal policies, and regulations of various regulatory authorities. Lending activities are influenced by the demand for and supply of business credit, single family and commercial properties, competition among lenders, the level of interest rates and the availability of funds. Deposit flows and costs of deposits are influenced by prevailing market rates of interest on competing investments, account maturities and the levels of personal income and savings.

Beginning with the Company's 2008 fiscal year, the Company's commercial business and commercial real estate loan portfolios have required significant allowances and charge offs due primarily to decreases in the estimated value of the underlying collateral supporting the loans, as many of these loans were made to borrowers in or associated with the real estate industry. The decrease in the estimated collateral value is primarily the result of reduced demand for real estate, particularly as it relates to single-family and commercial land developments. More stringent lending standards implemented by the mortgage industry in recent years have made it more difficult for some borrowers with marginal credit to qualify for a mortgage. This decrease in available credit and the overall weakness in the economy over the past several years reduced the demand for single family homes and the values of existing properties and developments where the Company's commercial loan portfolio has concentrations. Consequently, our level of non-performing assets and the related provision for loan losses increased significantly in the past several years, relative to periods before 2008. The increased levels of non-performing assets, related provisions for loan losses and write offs of or allowances against goodwill and deferred taxes arising from adverse results of operations, were the primary reasons for the net losses incurred by the Company in each of the years 2008 through 2011.

#### ***Critical Accounting Policies***

Critical accounting policies are those policies that the Company's management believes are the most important to understanding the Company's financial condition and operating results. These critical accounting policies often involve estimates and assumptions that could have a material impact on the Company's financial statements. The Company has identified the following critical accounting policies that management believes involve the most difficult, subjective, and/or complex judgments that are inherently uncertain. Therefore, actual financial results could differ significantly depending upon the estimates, assumptions and other factors used.

#### ***Allowance for Loan Losses and Related Provision***

The allowance for loan losses is based on periodic analysis of the loan portfolio. In this analysis, management considers factors including, but not limited to, specific occurrences of loan impairment, changes in the size of the portfolios, national and regional economic conditions such as unemployment data, loan portfolio composition, loan delinquencies, local economic growth rates, historical experience and observations made by the Company's ongoing internal audit and regulatory exam processes. Loans are charged off to the extent they are deemed to be uncollectible. The Company has established separate processes to determine the appropriateness of the loan loss allowance for its homogeneous single-family and consumer loan portfolios and its non-homogeneous loan portfolios. The determination of the allowance on the homogeneous single-family and consumer loan portfolios is calculated on a pooled basis with individual determination of the allowance of all non-performing loans. The determination of the allowance for the non-homogeneous commercial, commercial real estate, and multi-family loan portfolios involves assigning standardized risk ratings and loss factors that are periodically reviewed. The loss factors are estimated based on the Company's own loss experience and are assigned to all loans without identified credit weaknesses. For each non-performing loan, the Company also performs an individual analysis of impairment that is based on the expected cash flows or the value of the assets collateralizing the loans and establishes any necessary reserves or charges off all loans or portion thereof that are deemed uncollectable.

The appropriateness of the allowance for loan losses is dependent upon management's estimates of variables affecting valuation, appraisals of collateral, evaluations of performance and status, and the amounts and timing of future cash flows expected to be received on impaired loans. Such estimates, appraisals, evaluations and cash flows may be subject to frequent adjustments due to changing economic prospects of borrowers or properties. The estimates are reviewed periodically and adjustments, if any, are recorded in the provision for loan losses in the periods in which the adjustments become known. Because of the size of some loans, changes in estimates can have a significant impact on the loan loss provision. The allowance is allocated to individual loan categories based upon the relative risk characteristics of the loan portfolios and the actual loss experience. The Company increases its allowance for loan losses by charging the provision for loan losses against income. The methodology for establishing the allowance for loan losses takes into consideration probable losses that have been identified in connection with specific loans as well as probable losses in the loan portfolio for which additional specific reserves are not required. Although management believes that based on current conditions the allowance for loan losses is maintained at an appropriate amount to provide for probable loan losses inherent in the portfolio as of the balance sheet date, future conditions may differ substantially from those anticipated in determining the allowance for loan losses and adjustments may be required in the future.

#### *Income Taxes*

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. These calculations are based on many complex factors including estimates of the timing of reversals of temporary differences, the interpretation of federal and state income tax laws and a determination of the differences between the tax and the financial reporting basis of assets and liabilities. Actual results could differ significantly from the estimates and interpretations used in determining the current and deferred income tax liabilities.

The Company maintains significant net deferred tax assets for deductible temporary differences, the largest of which relates to the allowance for loan and real estate losses and net operating loss carry forwards. For income tax purposes, only net charge-offs are deductible, not the entire provision for loan losses. Under generally accepted accounting principles, a valuation allowance is required to be recognized if it is more likely than not that the deferred tax asset will not be realized. The determination of the realizability of the deferred tax assets is highly subjective and dependent upon management's judgment and evaluation of both positive and negative evidence, including the forecasts of future income, tax planning strategies and assessments of the current and future economic and business conditions. The Company considers both positive and negative evidence regarding the ultimate realizability of deferred tax assets. Positive evidence includes the ability to implement tax planning strategies to accelerate taxable income recognition and the probability that taxable income will be generated in future periods. Negative evidence includes the Company's cumulative loss in the prior three year period, current financial performance, and the general business and economic trends. In the second quarter of 2010, the Company recorded a valuation allowance against the entire deferred tax asset balance and the Company continued to maintain a valuation reserve against the entire deferred tax asset balance at September 30, 2012. This determination was based primarily upon the existence of a three year cumulative loss position that is primarily attributable to significant provisions for loan losses incurred during the last three years. The creation of the valuation allowance, although it increased tax expense and similarly reduced tangible book value, does not have an effect on the Company's cash flows, and may be recoverable in subsequent periods if the Company were to realize certain sustained future taxable income. It is possible that future conditions may differ substantially from those anticipated in determining the need for a valuation allowance on deferred tax assets and adjustments may be required in the future.

Determining the ultimate settlement of any tax position requires significant estimates and judgments in arriving at the amount of tax benefits to be recognized in the financial statements. It is possible that the tax benefits realized upon the ultimate resolution of a tax position may result in tax benefits that are significantly different from those estimated.

**RESULTS OF OPERATIONS FOR THIRD QUARTER ENDED SEPTEMBER 30, 2012 COMPARED TO THIRD QUARTER ENDED SEPTEMBER 30, 2011*****Net Income (Loss)***

Net income was \$0.6 million for the third quarter of 2012, an improvement of \$2.7 million compared to a net loss of \$2.1 million for the third quarter of 2011. Net income available to common shareholders was \$0.2 million for the third quarter of 2012, an improvement of \$2.7 million, or 106.8%, from the net loss available to common shareholders of \$2.5 million for the third quarter of 2011. Diluted earnings per common share for the third quarter of 2012 was \$0.04, an increase of \$0.69, or 106.2%, from the diluted loss per common share of \$0.65 for the third quarter of 2011. The improvement in net income for the third quarter of 2012 is due to a \$2.7 million decrease in the provision for loan losses between the periods, a \$0.6 million increase in noninterest income due primarily to an increase in the gain on sales of loans, and a \$0.6 million decrease in noninterest expenses due primarily to the decrease in expenses related to real estate owned. These changes to net income were partially offset by a \$1.2 million decrease in net interest income due primarily to a decrease in interest-earning assets between the periods.

Net income was \$3.8 million for the nine-month period ended September 30, 2012, an improvement of \$7.7 million, from the \$3.9 million net loss for the nine-month period ended September 30, 2011. Net income available to common shareholders was \$2.4 million for the nine-month period ended September 30, 2012, an improvement of \$7.7 million, from the net loss available to common shareholders of \$5.3 million for the same period of 2011. Diluted earnings per common share for the nine-month period in 2012 was \$0.61, an improvement of \$1.99, from the diluted loss per common share of \$1.38 for the same period in 2011. The improvement in net income for the first nine months of 2012 is due to a \$7.1 million decrease in the provision for loan losses between the periods, a \$0.6 million gain on sale of the Bank's Toledo, Iowa branch, a \$1.5 million increase in the gain on sales of loans, and a \$2.3 million decrease in noninterest expenses due primarily to the decrease in expenses related to real estate owned. These improvements to net income were partially offset by a \$3.4 million decrease in net interest income due primarily to a decrease in interest earning assets between the periods.

***Net Interest Income***

Net interest income was \$5.9 million for the third quarter of 2012, a decrease of \$1.2 million, or 16.8%, compared to \$7.1 million for the third quarter of 2011. Interest income was \$7.6 million for the third quarter of 2012, a decrease of \$2.0 million, or 21.1%, from \$9.6 million for the same period in 2011. Interest income decreased between the periods primarily because of a \$145 million decrease in the average interest-earning assets and also because of a decrease in the average yields between the periods. Average interest-earning assets decreased between the periods primarily because of a decrease in the commercial loan portfolio, which occurred because of low loan demand and the Company's focus on improving credit quality, managing net interest margin and improving capital ratios. The average yield earned on interest-earning assets was 4.89% for the third quarter of 2012, a decrease of 12 basis points from the 5.01% average yield for the third quarter of 2011. The decrease in the average yield is due to the continued low interest rate environment that existed during the third quarter of 2012.

Interest expense was \$1.7 million for the third quarter of 2012, a decrease of \$0.8 million, or 33.3%, compared to \$2.5 million for the third quarter of 2011. Interest expense decreased primarily because of the \$150 million decrease in the average interest-bearing liabilities between the periods. The decrease in the average interest-bearing liabilities is primarily the result of a decrease in the average outstanding certificates of deposits and brokered deposits between the periods and a decrease in other deposits as a result of the Bank's Toledo, Iowa branch sale that was completed in the first quarter of 2012. The decrease in certificates of deposits and brokered deposits between the periods was the result of using the proceeds from loan principal payments to fund maturing certificates of deposit and brokered deposits. Interest expense also decreased because of the lower interest rates paid on money market accounts and certificates of deposits. The decreased rates were the result of the low interest rate environment that continued to exist during the third quarter of 2012. The average interest rate paid on interest-bearing liabilities was 1.14% for the third quarter of 2012, a decrease of 22 basis points from the 1.36% average interest rate paid in the third quarter of 2011.

Net interest margin (net interest income divided by average interest-earning assets) for the third quarter of 2012 was 3.82%, an increase of 11 basis points, compared to 3.71% for the third quarter of 2011. Net interest margin improved between the periods primarily because the rate paid on interest-bearing liabilities decreased more than the yield on interest-earning assets. The decrease in the rates paid on interest-bearing liabilities is primarily the result of a change in the mix of deposits as lower rate deposits were held during the third quarter of 2012 when compared to the same period in 2011. The change in the liability mix is primarily the result of a decrease in certificates of deposits and brokered deposits which is anticipated to continue.



Net interest income was \$18.2 million for the first nine months of 2012, a decrease of \$3.3 million, or 15.7%, from \$21.5 million for the same period in 2011. Interest income was \$23.8 million for the nine-month period ended September 30, 2012, a decrease of \$6.5 million, or 21.6%, from \$30.3 million for the same period in 2011. Interest income decreased between the periods primarily because of a \$141 million decrease in the average interest-earning assets and also because of a decrease in the average yields earned between the periods. Average interest-earning assets decreased between the periods primarily because of a decrease in the commercial loan portfolio, which occurred because of low loan demand and the Company's focus on improving credit quality, managing net interest margin and improving capital ratios. The average yield earned on interest-earning assets was 4.82% for the nine-month period of 2012, a decrease of 26 basis points from the 5.08% average yield for the nine-month period of 2011. The decrease in the average yield is due to the continued low interest rate environment that existed during the first nine months of 2012.

Interest expense was \$5.6 million for the nine-month period ended September 30, 2012, a decrease of \$3.2 million, or 36.1%, from \$8.8 million for the same period in 2011. Interest expense decreased primarily because of a \$142 million decrease in the average interest-bearing liabilities between the periods. The decrease in average interest-bearing liabilities is primarily the result of a decrease in the average outstanding certificates of deposit and brokered deposits between the periods. The average interest rate paid on interest-bearing liabilities was 1.20% for the nine-month period of 2012, a decrease of 34 basis points from the 1.54% average rate paid for the same nine-month period of 2011.

Net interest margin (net interest income divided by average interest-earning assets) was 3.68% for the nine-month period of 2012, an increase of 8 basis points from the 3.60% margin for the same nine-month period of 2011. Net interest margin improved between the periods primarily because the rate paid on interest-bearing liabilities decreased more than the yield on interest-earning assets. The decrease in rates paid on interest-bearing liabilities is primarily the result of a change in the mix of deposits as lower rate deposits were held during the first nine months of 2012 when compared to the same period in 2011. The change in the liability mix is primarily the result of a decrease in certificates of deposit and brokered deposits between the periods which is anticipated to continue.

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A summary of the Company's net interest margin for the three and nine-month periods ended September 30, 2012 and September 30, 2011 is as follows:

|   | For the three month period ended |                       |              |                             |                       |              |
|---|----------------------------------|-----------------------|--------------|-----------------------------|-----------------------|--------------|
|   | September 30, 2012               |                       |              | September 30, 2011          |                       |              |
|   | Average Outstanding Balance      | Interest Earned/ Paid | Yield/ Rate  | Average Outstanding Balance | Interest Earned/ Paid | Yield/ Rate  |
| <i>(Dollars in thousands)</i>   |                                  |                       |              |                             |                       |              |
| <b>Interest-earning assets:</b>   |                                  |                       |              |                             |                       |              |
| Securities available for sale   | \$ 76,631                        | 292                   | 1.52%        | \$ 121,286                  | 567                   | 1.85%        |
| Loans held for sale   | 3,559                            | 28                    | 3.16         | 1,498                       | 16                    | 4.24         |
| Mortgage loans, net   | 102,736                          | 1,631                 | 6.32         | 120,026                     | 1,589                 | 5.25         |
| Commercial loans, net   | 326,177                          | 4,761                 | 5.81         | 411,982                     | 6,388                 | 6.15         |
| Consumer loans, net   | 55,490                           | 789                   | 5.65         | 65,594                      | 975                   | 5.90         |
| Cash equivalents  | 45,299                           | 26                    | 0.23         | 33,738                      | 4                     | 0.05         |
| Federal Home Loan Bank stock  | 4,063                            | 24                    | 2.36         | 4,486                       | 33                    | 2.96         |
| <b>Total interest-earning assets</b>  | <b>613,955</b>                   | <b>7,551</b>          | <b>4.89</b>  | <b>758,610</b>              | <b>9,572</b>          | <b>5.01</b>  |
| <b>Interest-bearing liabilities:</b>  |                                  |                       |              |                             |                       |              |
| NOW accounts  | 61,502                           | 9                     | 0.06         | 69,981                      | 12                    | 0.07         |
| Savings accounts  | 39,998                           | 16                    | 0.16         | 38,205                      | 15                    | 0.16         |
| Money market accounts   | 110,649                          | 109                   | 0.39         | 123,267                     | 184                   | 0.59         |
| Certificates  | 194,831                          | 576                   | 1.18         | 251,799                     | 941                   | 1.48         |
| Brokered deposits   | 21,519                           | 94                    | 1.73         | 75,421                      | 471                   | 2.48         |
| Advances and other borrowings   | 70,000                           | 855                   | 4.86         | 70,978                      | 865                   | 4.84         |
| <b>Total interest-bearing liabilities</b>                                   | <b>498,499</b>                   |                       |              | <b>629,651</b>              |                       |              |
| Non-interest checking   | 77,281                           |                       |              | 96,614                      |                       |              |
| Other non-interest bearing deposits   | 1,139                            |                       |              | 1,148                       |                       |              |
| <b>Total interest-bearing liabilities and non-interest bearing deposits</b> | <b>\$ 576,919</b>                | <b>1,659</b>          | <b>1.14</b>  | <b>\$ 727,413</b>           | <b>2,488</b>          | <b>1.36</b>  |
| <b>Net interest income</b>  |                                  | <b>\$ 5,892</b>       |              |                             | <b>\$ 7,084</b>       |              |
| <b>Net interest rate spread</b>   |                                  |                       | <b>3.75%</b> |                             |                       | <b>3.65%</b> |
| <b>Net interest margin</b>  |                                  |                       | <b>3.82%</b> |                             |                       | <b>3.71%</b> |

|                                      | For the nine month period ended |                       |             |                             |                       |             |
|--------------------------------------|---------------------------------|-----------------------|-------------|-----------------------------|-----------------------|-------------|
|                                      | September 30, 2012              |                       |             | September 30, 2011          |                       |             |
|                                      | Average Outstanding Balance     | Interest Earned/ Paid | Yield/ Rate | Average Outstanding Balance | Interest Earned/ Paid | Yield/ Rate |
| <i>(Dollars in thousands)</i>        |                                 |                       |             |                             |                       |             |
| <b>Interest-earning assets:</b>      |                                 |                       |             |                             |                       |             |
| Securities available for sale        | \$ 89,466                       | 1,091                 | 1.63%       | \$ 141,500                  | 2,005                 | 1.89%       |
| Loans held for sale                  | 3,116                           | 75                    | 3.22        | 1,574                       | 52                    | 4.40        |
| Mortgage loans, net                  | 110,812                         | 4,509                 | 5.44        | 123,931                     | 5,044                 | 5.44        |
| Commercial loans, net                | 348,497                         | 15,476                | 5.93        | 429,312                     | 20,076                | 6.25        |
| Consumer loans, net                  | 58,081                          | 2,467                 | 5.67        | 66,984                      | 2,999                 | 5.99        |
| Cash equivalents                     | 44,256                          | 71                    | 0.21        | 29,835                      | 7                     | 0.03        |
| Federal Home Loan Bank stock         | 4,110                           | 89                    | 2.88        | 5,776                       | 148                   | 3.43        |
| <b>Total interest-earning assets</b> | <b>658,338</b>                  | <b>23,778</b>         | <b>4.82</b> | <b>798,912</b>              | <b>30,331</b>         | <b>5.08</b> |
| <b>Interest-bearing liabilities:</b> |                                 |                       |             |                             |                       |             |

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|   |                   |                  |              |                   |                  |              |
|---|-------------------|------------------|--------------|-------------------|------------------|--------------|
| NOW accounts  | 65,027            | 29               | 0.06         | 73,062            | 46               | 0.08         |
| Savings accounts  | 39,616            | 53               | 0.18         | 36,791            | 41               | 0.15         |
| Money market accounts   | 110,431           | 347              | 0.44         | 117,004           | 601              | 0.69         |
| Certificates  | 209,720           | 1,927            | 1.26         | 253,054           | 2,982            | 1.58         |
| Brokered deposits   | 41,621            | 726              | 2.33         | 90,424            | 1,699            | 2.51         |
| Advances and other borrowings   | 70,000            | 2,544            | 4.85         | 100,222           | 3,434            | 4.58         |
| <b>Total interest-bearing liabilities</b>                                   | <b>536,415</b>    |                  |              | <b>670,557</b>    |                  |              |
| Non-interest checking   | 87,072            |                  |              | 95,106            |                  |              |
| Other non-interest bearing deposits   | 1,156             |                  |              | 1,096             |                  |              |
| <b>Total interest-bearing liabilities and non-interest bearing deposits</b> | <b>\$ 624,643</b> | <b>5,626</b>     | <b>1.20</b>  | <b>\$ 766,759</b> | <b>8,803</b>     | <b>1.54</b>  |
| <b>Net interest income</b>  |                   | <b>\$ 18,152</b> |              |                   | <b>\$ 21,528</b> |              |
| Net interest rate spread  |                   |                  | 3.62%        |                   |                  | 3.54%        |
| <b>Net interest margin</b>  |                   |                  | <b>3.68%</b> |                   |                  | <b>3.60%</b> |

**Provision for Loan Losses**

The provision for loan losses was \$1.6 million for the third quarter of 2012, a decrease of \$2.7 million, compared to \$4.3 million for the third quarter of 2011. The provision decreased in the third quarter of 2012 primarily because there were fewer decreases in the estimated value of the underlying collateral supporting commercial real estate loans that required additional allowances or charge offs in the third quarter of 2012 when compared to the third quarter of 2011. The provision also decreased because of the \$123 million decrease in the loan portfolio between the periods.

The provision for loan losses was \$2.5 million for the first nine months of 2012, a decrease of \$7.2 million, from \$9.7 million for the same nine-month period in 2011. The provision decreased in the first nine months of 2012 primarily because there were fewer decreases in the estimated value of the underlying collateral supporting commercial real estate loans that required additional allowances or charge offs in the current period when compared to the same period of 2011. The provision also decreased because of the \$123 million decrease in the loan portfolio between the periods.

A reconciliation of the Company's allowance for loan losses for the three and nine-month periods ended September 30, 2012 and September 30, 2011 is summarized as follows:

| <i>(Dollars in thousands)</i> | 2012      | 2011      |
|-------------------------------|-----------|-----------|
| Balance at June 30,           | \$ 20,519 | \$ 27,764 |
| Provision                     | 1,584     | 4,260     |
| Charge offs:                  |           |           |
| One-to-four family            | 0         | (32)      |
| Consumer                      | (163)     | (143)     |
| Commercial business           | (168)     | (2,167)   |
| Commercial real estate        | (1,535)   | (4,094)   |
| Recoveries                    | 225       | 102       |
| Balance at September 30,      | \$ 20,462 | \$ 25,690 |
| General allowance             | \$ 15,965 | \$ 15,906 |
| Specific allowance            | 4,497     | 9,784     |
|                               | \$ 20,462 | \$ 25,690 |

| <i>(Dollars in thousands)</i> | 2012      | 2011      |
|-------------------------------|-----------|-----------|
| Balance at January 1,         | \$ 23,888 | \$ 42,828 |
| Provision                     | 2,544     | 9,669     |
| Charge offs:                  |           |           |
| One-to-four family            | 0         | (450)     |
| Consumer                      | (921)     | (230)     |
| Commercial business           | (1,997)   | (10,724)  |
| Commercial real estate        | (5,719)   | (16,303)  |
| Total charge offs             | (8,637)   | (27,707)  |
| Recoveries                    | 2,667     | 900       |
| Balance at September 30,      | \$ 20,462 | \$ 25,690 |

**Non-Interest Income**

Non-interest income was \$2.1 million for the third quarter of 2012, an increase of \$0.6 million, or 39.3%, from \$1.5 million for the same period in 2011. Gain on sales of loans increased \$0.8 million primarily because of an increase in single family loan originations and sales and also because of an increase in the sale of commercial government guaranteed loans between the periods. Fees and service charges decreased \$0.2

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million primarily because of a decrease in overdraft charges between the periods which was partly due to the reduction in deposit accounts as a result of the sale of the Toledo, Iowa branch in the first quarter of 2012.

Non-interest income was \$6.6 million for the first nine months of 2012, an increase of \$1.7 million, or 35.2%, from \$4.9 million for the same period in 2011. Gain on sales of loans increased \$1.5 million, or 150.9%, between the periods as a result of an increase in single family loan originations and sales due to the low interest rate environment that existed during the first nine months of 2012. Gain on sale of branch office increased \$0.6 million as a result of the sale of the Toledo, Iowa branch in the first quarter of 2012. Fees and service charges decreased \$0.3 million primarily because of a decrease in overdraft charges between the periods. Other non-interest income increased \$0.1 million due primarily to an increase in the sale of uninsured investment products and an increase in rental income on other real estate owned. Mortgage servicing fees decreased \$34,000 between the periods primarily because of a decrease in the number of single family mortgage loans that are being serviced for others.

#### ***Non-Interest Expense***

Non-interest expense was \$5.8 million for the third quarter of 2012, a decrease of \$0.6 million, or 9.5%, from \$6.4 million for the same period of 2011. Compensation and benefits expense decreased \$0.3 million between the periods primarily because of a decrease in the compensation paid as a result of having fewer employees. Gain on real estate owned increased \$0.3 million between the periods as there were more gains realized on the sale of real estate owned and there were fewer write downs in the value of the real estate owned in the third quarter of 2012 when compared to the same period in 2011. Occupancy expense decreased \$0.1 million primarily because of a decrease in depreciation and other expenses as a result of having fewer branch facilities. Other non-interest expenses decreased \$0.1 million primarily because of a decrease in the costs related to other real estate owned. Deposit insurance expense increased \$0.2 million primarily because of an increase in the insurance rates between the periods.

Non-interest expense was \$18.4 million for the first nine months of 2012, a decrease of \$2.3 million, or 11.1%, from \$20.7 million for the same period in 2011. Other non-interest expense decreased \$0.9 million because of decreased real estate taxes and legal fees related to other real estate owned. Compensation and benefits expense decreased \$0.8 million primarily because of a decrease in the compensation paid as a result of having fewer employees. Gain on real estate owned improved \$0.4 million between the periods as there were more gains realized on the sale of real estate and there were fewer write downs in the value of the real estate owned in the first nine months of 2012 when compared to the same period of 2011. Occupancy expense decreased \$0.3 million primarily because of a decrease in depreciation and other expenses as a result of having fewer branch facilities. Deposit insurance expense decreased \$0.1 million primarily because of the decrease in assets between the periods. Data processing costs increased \$0.1 million between the periods primarily because of an incentive that was received by the Company in the first quarter of 2011 related to a change in our ATM and debit card vendor.

#### ***Income Tax Expense***

No income tax expense was recorded for the third quarter or the first nine months of 2012 or for the third quarter or the first nine months of 2011. In the second quarter of 2010, the Company recorded a deferred tax asset valuation reserve against its entire deferred tax asset balance and the Company continued to maintain a valuation reserve against the entire deferred tax asset balance at September 30, 2012. Since the valuation reserve is established against the entire deferred tax asset balance, no income tax expense was recorded for the third quarter or first nine months of 2012 or 2011.

#### ***Net Income (Loss) Available to Common Shareholders***

Net income available to common shareholders was \$0.2 million for the third quarter of 2012, an increase of \$2.7 million from the \$2.5 million net loss available to common shareholders in the third quarter of 2011. Net income available to common shareholders was \$2.4 million for the first nine months of 2012, an increase of \$7.7 million from the \$5.3 million net loss available to common shareholders in the same period of 2011. The net income available to common shareholders increased primarily because of the change in the net income (loss) between the periods.

The Company has deferred the last seven quarterly dividend payments, beginning with the February 15, 2011 dividend payment, on its Fixed Rate Cumulative Perpetual Preferred Stock, Series A issued to the United States Treasury Department as part of the TARP Capital Purchase Program. The deferred dividend payments have been accrued for payment in the future and are being reported for the deferral period as a preferred dividend requirement that is deducted from net income for financial statement purposes to arrive at the net income (loss) available to common shareholders. Under the terms of the certificate of designations for the preferred stock, dividend payments may be deferred, but the dividend is cumulative and, since the Company failed to pay dividends for six quarters, the Treasury has the right to appoint two representatives to the Company's board of directors. The Treasury has not yet exercised

this right. Under the terms of the Company's and Bank's Supervisory Agreements with their federal banking regulators, neither the Company nor the Bank may declare or pay any cash dividends, or purchase or redeem any capital stock, without prior notice to, and consent of these regulators. The Company does not anticipate requesting consent from the Federal Reserve Board to make any payments of dividends on, or purchase of, its common or preferred stock in 2012.

## FINANCIAL CONDITION

### Non-Performing Assets

The following table summarizes the amounts and categories of non-performing assets, which consist of non-performing loans and foreclosed and repossessed assets, in the Bank's portfolio and loan delinquency information as of the end of the two most recently completed quarters and December 31, 2011.

| <i>(Dollars in thousands)</i>   | September 30,<br>2012 | June 30,<br>2012 | December 31,<br>2011 |
|---|-----------------------|------------------|----------------------|
| <b>Non-Performing Loans:</b>  |                       |                  |                      |
| One-to-four family real estate  | \$ 2,992              | \$ 4,409         | \$ 4,435             |
| Commercial real estate  | 27,707                | 22,322           | 22,658               |
| Consumer  | 317                   | 367              | 699                  |
| Commercial business   | 3,566                 | 3,993            | 6,201                |
| <b>Total</b>  | <b>34,582</b>         | <b>31,091</b>    | <b>33,993</b>        |
| <b>Foreclosed and Repossessed Assets:</b>                                       |                       |                  |                      |
| One-to-four family real estate  | 320                   | 334              | 352                  |
| Commercial real estate  | 12,297                | 12,398           | 16,264               |
| <b>Total non-performing assets</b>  | <b>\$ 47,199</b>      | <b>\$ 43,823</b> | <b>\$ 50,609</b>     |
| <b>Total as a percentage of total assets</b>                                    | <b>7.33%</b>          | <b>6.54%</b>     | <b>6.40%</b>         |
| <b>Total non-performing loans</b>   | <b>\$ 34,582</b>      | <b>\$ 31,091</b> | <b>\$ 33,993</b>     |
| <b>Total as a percentage of total loans receivable, net</b>                     | <b>7.29%</b>          | <b>6.27%</b>     | <b>6.10%</b>         |
| <b>Allowance for loan losses to non-performing loans</b>                        | <b>59.2%</b>          | <b>66.00%</b>    | <b>70.27%</b>        |
| <b>Delinquency Data:</b>  |                       |                  |                      |
| <b>Delinquencies <sup>(1)</sup></b>   |                       |                  |                      |
| 30+ days  | \$ 5,077              | \$ 6,412         | \$ 3,226             |
| 90+ days  | 0                     | 0                | 0                    |
| <b>Delinquencies as a percentage of loan and lease portfolio <sup>(1)</sup></b> |                       |                  |                      |
| 30+ days  | 0.98%                 | 1.24%            | 0.54%                |
| 90+ days  | 0.00%                 | 0.00%            | 0.00%                |

(1) Excludes non-accrual loans.

Total non-performing assets were \$47.2 million at September 30, 2012, an increase of \$3.4 million, or 7.7%, from \$43.8 million at June 30, 2012. Non-performing loans increased \$3.5 million and foreclosed and repossessed assets decreased \$0.1 million during the third quarter of 2012. The non-performing loan and foreclosed and repossessed asset activity for the quarter was as follows:

*(Dollars in thousands)*

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|                                  |           |
|----------------------------------|-----------|
| <b>Non-performing loans</b>      |           |
| June 30, 2012                    | \$ 31,091 |
| Classified as non-performing     | 11,155    |
| Charge offs                      | (1,866)   |
| Principal payments received      | (3,645)   |
| Classified as accruing           | (782)     |
| Transferred to real estate owned | (1,371)   |

September 30, 2012 \$ 34,582

|  |           |
|--|-----------|
| <b>Foreclosed and repossessed assets</b> |           |
| June 30, 2012                            | \$ 12,732 |
| Transferred from non-performing loans    | 1,371     |
| Real estate sold                         | (1,644)   |
| Net gain on sale of assets               | 172       |
| Write downs and payments                 | (14)      |
| September 30, 2012                       | \$ 12,617 |

The increase in non-performing loans relates primarily to new loans that were classified as non-performing during the quarter. Of the \$11.2 million in loans classified as non-performing in the third quarter of 2012, \$9.5 million related to three loans on two residential developments because the cash flows from lot sales were not sufficient to support the required principal payments on the loans. The largest non-performing loan relationship at September 30, 2012 was for \$7.3 million and is secured by a residential development located in the Bank's market area.



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Total non-performing assets were \$47.2 million at September 30, 2012, a decrease of \$3.4 million, or 6.7%, from \$50.6 million at December 31, 2011. Non-performing loans increased \$0.6 million and foreclosed and repossessed assets decreased \$4.0 million during the first nine months of 2012. The non-performing loan and foreclosed and repossessed asset activity for the first nine months of 2012 was as follows:

(Dollars in thousands)

**Non-performing loans**

|                                  |           |
|----------------------------------|-----------|
| January 1, 2012                  | \$ 33,993 |
| Classified as non-performing     | 22,514    |
| Charge offs                      | (8,637)   |
| Principal payments received      | (10,129)  |
| Classified as accruing           | (1,200)   |
| Transferred to real estate owned | (1,959)   |
| September 30, 2012               | \$ 34,582 |

**Foreclosed and repossessed assets**

|                                       |           |
|---------------------------------------|-----------|
| January 1, 2012                       | \$ 16,616 |
| Transferred from non-performing loans | 1,959     |
| Real estate sold                      | (5,878)   |
| Net gain on sale of assets            | 521       |
| Write downs and payments              | (601)     |
| September 30, 2012                    | \$ 12,617 |

The following table summarizes the number of lending relationships and types of commercial real estate loans that were non-performing as of the end of the two most recent quarters and December 31, 2011.

(Dollars in thousands)

| Property Type           | #  | Principal Amount of Loans<br>September 30,<br>2012 | #  | Principal Amount of Loans<br>June 30,<br>2012 | #  | Principal Amount of Loans<br>December 31,<br>2011 |
|-------------------------|----|--|----|---|----|---|
| Developments/land       | 12 | \$ 26,415  | 13 | \$ 20,630                                     | 10 | \$ 17,465   |
| Shopping centers/retail | 2  | 396  | 2  | 406   | 2  | 1,315   |
| Restaurants/bar         | 1  | 565  | 1  | 581   | 1  | 616   |
| Office buildings        | 2  | 184  | 2  | 184   | 1  | 2,325   |
| Other buildings         | 1  | 147  | 2  | 521   | 3  | 937   |
|                         | 18 | \$ 27,707  | 20 | \$ 22,322                                     | 17 | \$ 22,658   |

The increase in the non-performing commercial real estate loans from June 30, 2012 is due primarily to three loans on two residential developments totaling \$9.5 million that were classified as non-performing during the third quarter of 2012 because the cash flows from lot sales were not sufficient to support the required principal payments on the loans.

The following table summarizes the number of lending relationships and industry of commercial business loans that were non-performing for the two most recent quarters and December 31, 2011.

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(Dollars in thousands)

| Industry Type                 | #  | Principal<br>Amount of Loan<br>September 30,<br>2012 | #  | Principal<br>Amount of Loan<br>June 30,<br>2012 | #  | Principal<br>Amount of<br>Loan<br>December 31,<br>2011 |
|-------------------------------|----|--|----|---|----|--|
| Construction/development/land | 6  | \$ 1,650   | 6  | \$ 1,796  | 6  | \$ 2,061   |
| Retail                        | 2  | 247  | 2  | 202   | 1  | 82   |
| Banking                       | 0  | 0  | 0  | 0   | 2  | 1,199  |
| Entertainment                 | 1  | 16   | 1  | 20  | 1  | 23   |
| Utilities                     | 2  | 1,379  | 2  | 1,394   | 1  | 2,792  |
| Restaurant                    | 1  | 135  | 1  | 498   | 0  | 0  |
| Other                         | 3  | 139  | 2  | 83  | 1  | 44   |
|                               | 15 | \$ 3,566   | 14 | \$ 3,993  | 12 | \$ 6,201   |

**Dividends**

The declaration of dividends is subject to, among other things, the Company's financial condition and results of operations, the Bank's compliance with its regulatory capital requirements, tax considerations, industry standards, economic conditions, regulatory restrictions, general business practices and other factors. Under the Bank Supervisory Agreement, no dividends can be declared or paid by the Bank to the Company without prior regulatory approval. The payment of dividends by the Company is dependent upon the Company having adequate cash or other assets that can be converted to cash to pay dividends to its stockholders. In addition, under the terms of the Company's Supervisory Agreement, the Company may not declare or pay any cash dividends, or purchase or redeem any capital stock, without prior notice to, and consent of its regulator. The Company suspended the dividend payments to common stockholders in the fourth quarter of 2008 due to the net operating losses experienced and the challenging economic environment.

The Company has deferred the last seven quarterly dividend payments, beginning with the February 15, 2011 dividend payment, on its Fixed Rate Cumulative Perpetual Preferred Stock, Series A, issued to the United States Treasury Department as part of the TARP Capital Purchase Program. The deferred dividend payments have been accrued for payment in the future and are being reported for the deferral period as a preferred dividend requirement that is deducted from income for financial statement purposes to arrive at the net income (loss) available to common shareholders. Under the terms of the certificate of designations for the preferred stock, dividend payments may be deferred, but the dividend is cumulative and, since the Company failed to pay dividends for six quarters, the Treasury has the right to appoint two representatives to the Company's board of directors. The Treasury has not yet exercised this right. Under the terms of the Company's and Bank's Supervisory Agreements with their federal banking regulators, neither the Company nor the Bank may declare or pay any cash dividends, or purchase or redeem any capital stock, without prior notice to, and consent of these regulators. The Company does not anticipate requesting consent from the Federal Reserve Board to make any payments of dividends on, or purchase of, its common or preferred stock in 2012.

## LIQUIDITY AND CAPITAL RESOURCES

For the nine months ended September 30, 2012, the net cash provided by operating activities was \$13.2 million. The Company collected \$103.0 million from the maturities of securities, \$8.0 million from principal repayments on securities, \$0.2 million from the redemption of FHLB stock, and \$5.9 million in proceeds from the sale of real estate. The Company purchased securities of \$44.0 million, purchased premises and equipment of \$0.2 million, and paid \$37.5 million in connection with the Toledo, Iowa branch sale. Net loans receivable decreased \$69.7 million due primarily to decreased commercial loan production. The Company had a net decrease in deposit balances of \$110.0 million (primarily in brokered deposits) and paid out \$0.5 million in customer escrows.

The Company has certificates of deposits with outstanding balances of \$133.0 million that come due over the next 12 months, of which \$8.4 million were obtained from brokers. Based upon past experience, management anticipates that the majority of the deposits will renew for another term, with the exception of the brokered deposits that are not anticipated to renew due to the Company's desire to reduce the amount of outstanding brokered deposits. In addition, based on a regulatory directive, the Bank may not renew existing brokered deposits, or accept new brokered deposits without the prior consent of the OCC. The Company believes that deposits that do not renew will be repaid with proceeds from loan principal payments or replaced with a combination of other customer's deposits, FHLB advances or Federal Reserve Bank borrowings. Proceeds from the sale of securities could also be used to fund unanticipated outflows of deposits.

The Company had three deposit customers with aggregate deposits greater than \$5.0 million as of September 30, 2012. The \$21.1 million in funds held by these customers may be withdrawn at any time, however, management does not anticipate that these deposits will be withdrawn from the Bank over the next twelve months. If these deposits were to be withdrawn, we would expect them to be replaced with deposits from other customers or brokers, subject to regulatory approval. FHLB advances, Federal Reserve borrowings or proceeds from the sale of securities could also be used to replace unanticipated outflows of large checking and money market deposits.

At September 30, 2012, the Bank had the ability to draw additional borrowings from the FHLB of \$59.8 million based upon the collateral pledged, subject to a requirement to purchase additional FHLB stock and the FHLB agreeing to lend. The Bank also has the ability to draw additional borrowings of \$28.7 million from the Federal Reserve Bank, based upon the loans pledged with them. Under the Company Supervisory Agreement, the Company may not incur or issue any debt without prior notice to, and the consent of, its primary regulator (FRB). Because FHLB advances and Federal Reserve Bank borrowings are debt of the Bank, they are not affected by the Company's restriction on incurring debt.

The credit policy of the FHLB relating to the collateral value of the loans collateralizing the outstanding advances with the FHLB may change such that the current collateral pledged to secure the advances is no longer acceptable or the formulas for determining the excess pledged collateral may change. If this were to happen, the Bank may not have additional collateral to pledge to secure the existing advances and the Bank may have to find alternative funding sources to replace some of the FHLB advances maturing in 2013. The FHLB could also reduce the amount of funds it will lend to the Bank. It is not anticipated that the Bank will need to find alternative funding sources to replace the outstanding FHLB advances, but if needed, excess collateral currently pledged to the FHLB could be pledged to the

FRB and the Bank could borrow additional funds from the FRB based on the increased collateral levels or obtain additional deposits.

The Company's primary source of cash is dividends from the Bank and the Bank is restricted under the Bank Supervisory Agreement from paying dividends to the Company without obtaining prior regulatory approval. At September 30, 2012, the Company had \$1.1 million in cash and other assets that could readily be turned into cash. The primary use of cash by the Company is the payment of expenses. The amount of the dividend on the preferred stock accumulates at the rate of \$325,000 per quarter through February 14, 2014 and \$585,000 per quarter thereafter, if the shares of preferred stock are not redeemed. The Company has deferred the last seven quarterly dividend payments, beginning with the February 15, 2011 dividend payment, on its Fixed Rate Cumulative Perpetual Preferred Stock, Series A issued to the United States Treasury Department as part of the TARP Capital Purchase Program and has determined that it will defer the November 15, 2012 payment. Since the Company has failed to pay the dividends for six quarters, the Treasury has the right to appoint two representatives to the Company's board of directors. The Treasury has not yet exercised this right. The total amount of accrued but unpaid preferred stock dividends totaled \$2.4 million at September 30, 2012. In addition, under the terms of the Company's Supervisory Agreement, the Company may not declare or pay any cash dividends without prior notice to, and consent of, the OCC.

As required by the Company Supervisory Agreement, the Company submitted an updated two-year capital plan in January of 2012 that the Federal Reserve Board may make comments upon, and to which it may require revisions. The Company must operate within the parameters of the final capital plan and is required to monitor and submit periodic reports on its compliance with the plan. In addition, the OCC has established an IMCR for the Bank. An IMCR requires a bank to establish and maintain levels of capital greater than those generally required for a bank to be classified as well-capitalized. Effective December 31, 2011, the Bank was required to establish, and subsequently maintain, core capital at least equal to 8.5% of adjusted total assets, which was in excess of the Bank's 7.14% core capital to adjusted total assets ratio at December 31, 2011. In February 2012, the Bank received a notice from the OCC arising out of its failure to establish and maintain its IMCR of 8.5% core capital to adjusted total assets at December 31, 2011. In accordance with this notice, by April 30, 2012, the OCC required the Bank to submit a further written capital plan of how it intends to achieve and maintain its IMCR, and a contingency plan in the event the IMCR is not achieved through the Bank's primary plan. In April 2012, the Bank submitted the required revised capital and contingency plan to the OCC upon which they may make comments, and to which they may require revisions. Because of the improved financial results and the decrease in assets experienced during the first nine months of 2012, the Bank's core capital ratio improved to 8.50% at March 31, 2012, 9.04% at June 30, 2012, and 9.55% at September 30, 2012. There can be no assurance that the Bank will continue to maintain compliance with the IMCR in the future. The Bank's failure to comply with the terms of the IMCR at December 31, 2011 was, and its failure to continue to comply can be, deemed an unsafe and unsound banking practice and could subject it to further limits on growth and such legal actions or sanctions as the OCC considers appropriate.

In order to improve its capital ratios and maintain compliance with its IMCR, the Bank is, among other things, working to improve its financial results, reduce non-performing assets, and decrease the asset size of the Bank. In March 2012, the Bank also sold substantially all of the assets and liabilities associated with its Toledo, Iowa branch. If capital conditions were to deteriorate, the Bank may also determine it to be necessary or prudent to dispose of other non-strategic assets. These actions may result in changes in the Bank's assets, liabilities and earnings, some of which may be material, during the period in which the action is taken or is consummated or over a longer period of time.

The Company also serves as a source of capital, liquidity and financial support to the Bank. Based on the operating performance of the Bank or other capital demands, including the Bank's failure to maintain the outstanding IMCR, the Company may need, or be required by supervising bank regulators, to raise additional capital. If the Company raises capital through the issuance of additional shares of common stock or other equity securities, it would dilute the ownership interests of existing stockholders and, given our current common stock trading price, would be expected to dilute the per share book value of the Company's common stock and could result in a change of control of the Company and the Bank. New investors may also have rights, preferences and privileges senior to the Company's current stockholders, which may adversely impact the Company's current stockholders. The Company's ability to raise additional capital through the issuance of equity securities, if needed, will depend on conditions in the capital

markets at that time, which are outside of its control, and on the Company's financial performance. Accordingly, the Company may not be able to raise additional capital, if needed, on favorable economic terms, or other terms acceptable to it. If the Company or the Bank cannot satisfactorily address their respective capital needs as they arise, the Company's ability to maintain or expand its operations, their ability to maintain the Company's capital plan and the Bank IMCR, operate without additional regulatory or other restrictions, and its operating results, could be materially adversely affected.

The capital requirements of the Company and the Bank may be affected in the future by recently proposed regulatory changes. In June 2012, the Federal Reserve Board, the FDIC and the OCC jointly proposed new capital rules (Proposed Rules) that among other things, if adopted, would require the Company and the Bank to (1) establish a new minimum common equity Tier 1 ratio of 4.5% of risk-weighted assets; (2) raise the minimum Tier 1 capital ratio from 4.0% to 6.0% of risk-weighted assets; (3) maintain the minimum total capital ratio of 8.0% of risk-weighted assets; and (4) maintain a minimum Tier 1 capital to adjusted total assets of 4.0%. These changes would be phased in incrementally beginning January 1, 2013 to provide time for banking organizations to meet the new capital standards, with full implementation to occur by January 1, 2015.

In addition, the Proposed Rules would add a requirement for a minimum common equity Tier 1 capital conservation buffer of 2.5% of risk-weighted assets (Conservation Buffer) to be applied to the common equity Tier 1 capital ratio, the Tier 1 capital ratio and the total capital ratio. Therefore, application of the Conservation Buffer would result in (1) a common equity Tier 1 ratio of 7% of risk-weighted assets; (2) a Tier 1 capital ratio of 8.5% of risk-weighted assets; and (3) a total capital ratio of 10.0% of risk-weighted assets. Failure to maintain the Conservation Buffer would result in restrictions on capital distributions and certain discretionary cash bonus payments to executive officers. The required minimum Conservation Buffer would be phased in incrementally beginning January 1, 2016. An institution would be subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital falls below the Conservation Buffer. These limitations would establish a maximum percentage of eligible retained income that could be utilized for such actions.

The Proposed Rules would also revise the definition of capital to improve the ability of regulatory capital instruments to absorb losses and revise the rules for calculating risk-weighted assets to enhance risk sensitivity, which will exclude certain non-qualifying capital instruments, including cumulative preferred stock (other than preferred securities issued in connection with the TARP Capital Purchase Program) and trust preferred securities, as a component of Tier 1 capital. The Proposed Rules set forth certain changes for the calculation of risk-weighted assets, which the Company and the Bank would be required to utilize beginning January 1, 2015. The Proposed Rules utilize an increased number of credit risk exposure categories and risk weights, and also addresses: (1) a proposed alternative standard of creditworthiness consistent with Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act; (2) revisions to recognition of credit risk mitigation; (3) rules for risk weighting of equity exposures and past due loans; and (4) revised capital treatment for derivatives and repo-style transactions.

The Proposed Rules also revise certain of the prompt corrective action regulations described above. These revisions would take effect January 1, 2015. Under the prompt corrective action regulations, the Bank would be required to meet the following increased capital level requirements in order to qualify as well capitalized: (1) a new common equity Tier 1 capital ratio of 6.5% of risk-weighted assets; (2) a Tier 1 capital ratio of 8% (increased from 6%) of risk-weighted assets; (3) a total capital ratio of 10% (unchanged from current rules) of risk-weighted assets; and (4) a Tier 1 capital to adjusted total assets ratio of 5% (unchanged from current rules). The IMCR requirement discussed above is currently higher than the Tier 1 capital to adjusted total assets of 5.0% that would be required by the Proposed Rules.

The Company and the Bank are reviewing the potential impact of the Proposed Rules on its future capital requirements.

### **Market Risk**

Market risk is the risk of loss from adverse changes in market prices and rates. The Company's market risk arises primarily from interest rate risk inherent in its investing, lending and deposit taking activities. Management actively monitors and manages its interest rate risk exposure.

The Company's profitability is affected by fluctuations in interest rates. A sudden and substantial change in interest rates may adversely impact the Company's earnings to the extent that the interest rates borne by assets and liabilities do not change at the same speed, to the same extent, or on the same basis. The Company monitors the projected

changes in net interest income that occur if interest rates were to suddenly change up or down. The *Rate Shock Table* located in the Asset/Liability Management section of this report, which follows, discloses the Company's projected changes in net interest income based upon immediate interest rate changes called rate shocks.

The Company utilizes a model that uses the discounted cash flows from its interest-earning assets and its interest-bearing liabilities to calculate the current market value of those assets and liabilities. The model also calculates the changes in market value of the interest-earning assets and interest-bearing liabilities due to different interest rate changes.

The following table discloses the projected changes in market value to the Company's interest-earning assets and interest-bearing liabilities based upon incremental 100 basis point changes in interest rates from interest rates in effect on September 30, 2012.

| Other than trading portfolio<br>(Dollars in thousands) | Market Value |         |         |         |
|--|--------------|---------|---------|---------|
|  | -100         | 0       | +100    | +200    |
| Basis point change in interest rates                   |              |         |         |         |
| Total market risk sensitive assets                     | \$ 654,757   | 647,074 | 636,799 | 626,253 |
| Total market risk sensitive liabilities                | 596,796      | 578,904 | 565,608 | 553,316 |
| Off-balance sheet financial instruments                | (837)        | 0       | (268)   | (456)   |
| Net market risk  | \$ 58,798    | 68,170  | 71,459  | 73,393  |
| Percentage change from current market value            | (13.75)%     | 0.00%   | 4.82%   | 7.66%   |

The preceding table was prepared utilizing the following assumptions (Model Assumptions) regarding prepayment and decay ratios, which were determined by management based upon their review of historical prepayment speeds and future prepayment projections. Fixed rate loans were assumed to prepay at annual rates of between 5% to 68%, depending on the note rate and the period to maturity. Adjustable rate mortgages (ARMs) were assumed to prepay at annual rates of between 14% and 35%, depending on the note rate and the period to maturity. Mortgage-backed securities and collateralized mortgage obligations (CMOs) were projected to have prepayments based upon the underlying collateral securing the instrument and the related cash flow priority of the CMO tranche owned. Certificate accounts were assumed not to be withdrawn until maturity. Passbook accounts were assumed to decay at an annual rate of 9% and money market accounts were assumed to decay at an annual rate of 12%. Non-interest checking and NOW accounts were assumed to decay at an annual rate of 8%. Commercial NOW accounts and MMDA accounts were assumed to decay at an annual rate of 12%, respectively. Commercial non-interest checking accounts were assumed to decay at an annual rate of 10%. FHLB advances were projected to be called at the first call date where the projected interest rate on similar remaining term advances exceeded the interest rate on the callable advance or investment.

Certain shortcomings are inherent in the method of analysis presented in the foregoing table. The interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types of assets and liabilities may lag behind changes in market interest rates. The model assumes that the difference between the current interest rate being earned or paid compared to a treasury instrument or other interest index with a similar term to maturity (the Interest Spread) will remain constant over the interest changes disclosed in the table. Changes in Interest Spread could impact projected market value changes. Certain assets, such as ARMs, have features which restrict changes in interest rates on a short-term basis and over the life of the assets. The market value of the interest-bearing assets which are approaching their lifetime interest rate caps could be different from the values disclosed in the table. In the event of a change in interest rates, prepayment and early withdrawal levels may deviate significantly from those assumed in calculating the foregoing table. The ability of many borrowers to service their debt may decrease in the event of a substantial sustained interest rate increase.

#### **Asset/Liability Management**

The Company's management reviews the impact that changing interest rates will have on its net interest income projected for the twelve months following September 30, 2012 to determine if its current level of interest rate risk is acceptable. The following table projects the estimated annual impact on net interest income during the 12 month period ending September 30, 2013 of immediate interest rate changes called rate shocks.

*(Dollars in thousands)*

| Rate Shock in<br>Basis Points | Projected<br>Change in Net<br>Interest Income | Percentage<br>Change |
|-------------------------------|---|----------------------|
| +200                          | 1,282   | 6.58%                |
| +100                          | 601   | 3.08%                |
| 0                             | 0   | 0.00%                |
| -100                          | (1,211)                                       | (6.21)%              |

The preceding table was prepared utilizing the Model Assumptions. Certain shortcomings are inherent in the method of analysis presented in the foregoing table. In the event of a change in interest rates, prepayment and early withdrawal levels would likely deviate significantly from those assumed in calculating the foregoing table. The ability of many borrowers to service their debt may decrease in the event of a substantial increase in interest rates and could impact net interest income. The increase in interest income in a rising rate environment is primarily because more loans than deposits are scheduled to reprice in the next twelve months.

In an attempt to manage its exposure to changes in interest rates, management closely monitors interest rate risk. The Bank has an Asset/Liability Committee which meets frequently to discuss changes in the interest rate risk position and projected profitability. The Committee makes adjustments to the asset-liability position of the Bank, which are reviewed by the Board of Directors of the Bank. This Committee also reviews the Bank's portfolio, formulates investment strategies and oversees the timing and implementation of transactions to assure attainment of the Board's objectives in the most effective manner. In addition, each quarter the Board reviews the Bank's asset/liability position, including simulations of the effect on the Bank's capital of various interest rate scenarios.

In managing its asset/liability mix, the Bank, at times, depending on the relationship between long- and short-term interest rates, market conditions and consumer preference, may place more emphasis on managing net interest margin than on better matching the interest rate sensitivity of its assets and liabilities in an effort to enhance net interest income. Management believes that the increased net interest income resulting from a mismatch in the maturity of its asset and liability portfolios can, in certain situations, provide high enough returns to justify the increased exposure to sudden and unexpected changes in interest rates.

To the extent consistent with its interest rate spread objectives, the Bank attempts to manage its interest rate risk and has taken a number of steps to restructure its balance sheet in order to better match the maturities of its assets and liabilities. In the past, more fixed rate loans were placed into the single family loan portfolio. Over the past several years, the Bank has primarily focused its fixed rate one-to-four family residential lending program on loans that are saleable to third parties and generally placed only those fixed rate loans that met certain risk characteristics into its loan portfolio. The Bank's commercial loan production continued to be primarily in adjustable rate loans with minimum interest rate floors; however, more of these loans were structured to reprice every one, two, or three years.

#### ***Off-Balance Sheet Arrangements***

The Company has no off-balance sheet arrangements other than commitments to originate, fund, and sell loans in the ordinary course of business.

#### **Item 4: Controls and Procedures**

*Evaluation of disclosure controls and procedures.* As of the end of the period covered by this report, the Company conducted an evaluation, under the supervision and with the participation of the principal executive officer and principal financial officer, of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (Exchange Act)). Based on this evaluation, the principal executive officer and principal financial officer concluded that the Company's disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

*Changes in internal controls.* There was no change in the Company's internal controls over financial reporting during the Company's most recently completed fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal controls over financial reporting.



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HMN FINANCIAL, INC.

**PART II - OTHER INFORMATION**

**Item 1. Legal Proceedings.**

From time to time, the Company is party to legal proceedings arising out of its lending and deposit operations. The Company is, and expects to become, engaged in a number of foreclosure proceedings and other collection actions as part of its collection activities. Litigation is often unpredictable and the actual results of litigation cannot be determined with any certainty.

The Company entered into a written Supervisory Agreement with the OTS effective February 22, 2011. The Supervisory Agreement replaced the prior memorandum of understanding that the Company entered into with the OTS on December 9, 2009. The material requirements of the Company Supervisory Agreement are as follows:

Submission of a written plan by May 31, 2011 for enhancing the consolidated capital of the Company for the period ending December 31, 2012 and review of performance no less than quarterly along with reports to the FRB (as successor to the OTS' role as regulator of the Company) within 45 days after the end of each calendar quarter. The plan submitted by the Company prior to May 31, 2011 focused on improvement in capital levels primarily through improved earnings, reduction in non-performing assets and reduction in total assets. As required, the Company submitted an updated two-year capital plan in January 2012.

The Company may not declare, make or pay any cash dividends or repurchase or redeem any of the Company's equity stock without providing advance notice to the FRB and receiving written non-objection.

The Company may not incur, issue, renew, rollover or pay interest or principal on any debt or commit to do so nor may it increase any current lines of credit or guarantee the debt of any entity without prior written notice and written non-objection of the FRB.

Limits were placed on contractual arrangements related to compensation or benefits with any directors or officers and the Company is prevented from making any golden parachute payments to officers, directors or employees.

The Bank also entered into a written Supervisory Agreement with the OTS, effective February 22, 2011. The Bank Supervisory Agreement replaced the prior memorandum of understanding that the Bank entered into with the OTS on December 9, 2009. The material requirements of the Bank Supervisory Agreement are as follows:

Submission of a business plan by May 31, 2011, addressing strategies for supporting the Bank's risk profile, improving earnings and profitability and stress testing. The Bank's Board is to review performance no less than quarterly and report to the OCC (as successor to the OTS' role as regulator of the Bank) within 45 days after the end of each calendar quarter. The plan submitted by the Bank prior to May 31, 2011 focused on improvement in capital levels primarily through improved earnings, reduction in non-performing assets and reduction in total assets. The OCC accepted the submitted plan with the expectation that the Bank would be in adherence with the OCC's Notification of Establishment of Higher Minimum Capital Ratios, dated August 8, 2011, requiring a minimum core capital ratio of 8.5% by December 31, 2011. The Bank submitted an updated two-year business plan in January 2012 to the OCC.

Submission of a detailed written plan prior to March 31, 2011 to reduce the Bank's problem assets. The plan submitted by the Bank by March 31, 2011 was accepted by the OCC and focused on improvement in the level of problem assets as a result of continuing the actions taken in 2010 and early 2011 by the Board and management to improve credit quality and more effectively identify and manage problem loans in a proactive manner.

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Development of individual written specific workout plans for certain large adversely classified loans or groups of loans and for foreclosed real estate owned by the Bank within 30 days of the Supervisory Agreement effective date. The plans developed by the Bank focused on improving the ultimate collection of these items by improving the Bank's collateral position or by an orderly liquidation of the collateral securing the assets.

Beginning with the quarter ended June 30, 2011, the Bank is to submit quarterly asset reports to the OCC within 50 days of quarter end. The reports submitted by the Bank focused on the status of workout plans, classified assets, actions taken to reduce problem assets and recommended revisions to the problem asset plan.

Development by April 30, 2011 of a loan modification policy. The policy developed by the Bank focuses on enhanced supporting documentation and procedures relating to all loan restructurings, including those not determined to be troubled debt restructurings.

Revision of the Bank's written credit concentration program and submission of the program by May 6, 2011 to the OTS. The plan addresses identifying, monitoring and controlling risk associated with concentrations of credit. The Bank has implemented the revisions and is monitoring the resulting information.

Improvement of the documentation relating to the allowance for loan and lease losses to ensure that it addressed OTS concerns. The documentation improvements related primarily to the inclusion of established specific reserves into the commercial loan migration charge-off analysis.

The Bank may not declare or pay any dividends or make any other capital distributions without providing advance request to the OCC and receiving written approval. The Supervisory Agreement also limits the Bank's growth in total assets in excess of specified amounts without prior regulatory approval. The Bank's assets grew in excess of the allowable amount in the third quarter of 2011; however, the Bank obtained prior approval from the OCC.

Limits are placed on contractual arrangements with third parties and contracts dealing with compensation or benefits with any directors or officers and the Bank is prevented from making any golden parachute payments to directors, officers and employees. The Company and Bank timely submitted all plans and programs required by the Supervisory Agreements. The Company believes that it and the Bank are in compliance with all provisions of the Supervisory Agreements as of September 30, 2012. The applicable regulator may comment on and require revision of any submitted plan, program or policy. Neither the Company nor the Bank have taken any actions, or sought approval for such actions, where prior regulatory approval is required by the Supervisory Agreements other than the restriction related to asset growth and changes to the business plan. In the third quarter of 2011, the Bank requested and obtained a non-objection waiver from the OCC related to the unanticipated growth in assets during the third quarter in an amount greater than the net interest credited on deposit liabilities during the prior quarter. The Bank also received no supervisory objection to the change in the previously submitted business plan as a result of the increase in assets. The increase in assets was due to unanticipated increases in commercial deposits during the third quarter of 2011 as a result of increased cash being held by a few of the Bank's commercial deposit customers.

The foregoing is merely a summary of the material terms of the Supervisory Agreements and reference is made to the full text of the Supervisory Agreements which are set forth as Exhibits 10.1 and 10.2 to the Company's Current Report on Form 8-K dated February 10, 2011.

Dissolution of the OTS did not have any material impact on the Supervisory Agreements as the Supervisory Agreements are now enforced by the FRB in the case of the Company's Supervisory Agreement and the OCC in the case of the Bank's Supervisory Agreement.

The OCC has established an IMCR for the Bank. An IMCR requires a bank to establish and maintain levels of capital greater than those generally required for a bank to be classified as well-capitalized. Effective December 31, 2011, the Bank was required to establish, and subsequently maintain, core capital at least equal to 8.5% of adjusted total assets, which was in excess of the Bank's 7.14% core capital to adjusted total assets ratio at December 31, 2011. In February 2012, the Bank received a notice from the OCC arising out of its failure to

establish and maintain its IMCR of 8.50% core capital to adjusted total assets at December 31, 2011. Pursuant to the notice, the OCC required the Bank to submit by April 30, 2012 a further written capital plan of how it intends to achieve and maintain its IMCR, and a contingency plan in the event the IMCR is not achieved through the Bank's primary plan. In April 2012, the Bank submitted to the OCC the required revised written capital and contingency plan which they may make comments upon, and require revisions. Because of improved financial results and a decrease in assets, the Bank's core capital ratio improved to 8.50% at March 31, 2012, 9.04% at June 30, 2012, and 9.55% at September 30, 2012. The Bank's failure to comply with the terms of the IMCR was, and its failure to continue to comply can be, deemed an unsafe and unsound banking practice.

There can be no assurance that the Company and the Bank will continue to maintain compliance with the Supervisory Agreements and the IMCR in the future. Under applicable banking regulations, the failure to satisfy the terms of the Supervisory Agreements and the IMCR, and failure to otherwise comply with applicable requirements as they arise, could subject the Company, the Bank and its directors and officers to such restrictions, legal actions or sanctions as the OCC or FRB considers appropriate. Possible sanctions include among others (i) the imposition of one or more cease and desist orders requiring corrective action, which are enforceable directives that may address any aspect of the Company or Bank management, operations or capital, including requirements to change management, raise equity capital, dispose of assets or effect a change of control; (ii) civil money penalties; and (iii) downgrades in the capital adequacy status of the Company and the Bank.

**Item 1A. Risk Factors**

See Part I, Item 1.A. of the Company's Annual Report on Form 10-K for the year ended December 31, 2011 for risk factors.

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

None.

**Item 3. Defaults Upon Senior Securities.**

The Company deferred its February 15, 2011, May 15, 2011, August 15, 2011, November 15, 2011, February 15, 2012, May 15, 2012, and August 15, 2012 regular quarterly cash dividend payments on its Fixed Rate Cumulative Perpetual Preferred Stock, Series A issued to the United States Treasury Department as part of the TARP Capital Purchase Program. The Company has also determined that it will defer its November 15, 2012 dividend payment and following that deferral, the Company will have an aggregate arrearage of \$2.7 million with respect to the preferred stock. For additional information on these dividend deferrals, please see Part I, Item 2, Management's Discussion and Analysis Financial Condition and Results of Operations - Liquidity and Capital Resources of our Form 10-Q.

Since the Company failed to pay dividends for six quarters, the Treasury has the right to appoint two representatives to the Company's board of directors. The Treasury has not yet exercised this right. Pending the election of any such director, the Treasury has requested, and the Company has agreed, to the attendance of an observer selected by Treasury at Company board of director meetings.

**Item 4. Mine Safety Disclosures.**

Not applicable.

**Item 5. Other Information.**

None.

**Item 6. Exhibits.**

Incorporated by reference to the index to exhibits included with this report immediately following the signature page.



**SIGNATURES**

Pursuant to the requirement of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

HMN FINANCIAL, INC.  
Registrant

Date: November 7, 2012

By: /s/ Bradley Krehbiel  
Bradley Krehbiel,  
Chief Executive Officer and President  
(Principal Executive Officer)

Date: November 7, 2012

By: /s/ Jon Eberle  
Jon Eberle,  
Chief Financial Officer  
(Principal Financial Officer)

HMN FINANCIAL, INC.

INDEX TO EXHIBITS

FOR FORM 10-Q

| Regulation S-K<br>Exhibit Number | Document Attached Hereto  | Reference<br>to Prior<br>Filing or<br>Exhibit | Sequential<br>Page Numbering<br>Where Attached<br>Exhibits Are<br>Located in This<br>Report |
|----------------------------------|---|---|---|
| 3.1                              | Amended and Restated Certificate of Incorporation   | *1  | N/A   |
| 3.2                              | Amended and Restated By-laws  | *2  | N/A   |
| 4                                | Form of Common Stock Certificate  | *3  | N/A   |
| 31.1                             | Rule 13a-14(a)/15d-14(a) Certification of CEO   | 31.1  | Filed electronically  |
| 31.2                             | Rule 13a-14(a)/15d-14(a) Certification of CFO   | 31.2  | Filed electronically  |
| 32                               | Section 1350 Certification of CEO and CFO   | 32  | Filed Electronically  |
| 101                              | Financial statements from the Quarterly Report on Form 10-Q of the Company for the period ended September 30, 2012, filed with the SEC on November 7, 2012, formatted in eXtensible Business Reporting Language (XBRL); (i) the Consolidated Balance Sheet at September 30, 2012 and December 31, 2011, (ii) the Consolidated Statement of Comprehensive Income (Loss) for the Three Months and Nine Months Ended September 30, 2012 and 2011, (iii) the Consolidated Statement of Stockholders' Equity for the Nine Month Period Ended September 30, 2012, (iv) the Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2012 and 2011, and (v) Notes to Consolidated Financial Statements. | 101   | Filed Electronically  |

\*1 Incorporated by reference to Exhibit 3(a) to the Company's Quarterly Report on Form 10-Q for the period ended March 31, 1998 (File No. 0-24100).

\*2 Incorporated by reference to Exhibit 3.1 of the Company's Current Report on Form 8-K filed March 5, 2012 (File 0-24100)

\*3 Incorporated by reference to the same numbered exhibit to the Company's Registration Statement on Form S-1 dated April 1, 1994 (File No. 33-77212).