

HMN FINANCIAL INC  
Form 10-Q  
November 03, 2008

**Table of Contents**

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-Q**

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

**For the quarterly period ended September 30, 2008**

**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)

Delaware

41-1777397

(State or other jurisdiction of incorporation or organization)

(I.R.S. Employer Identification Number)

1016 Civic Center Drive N.W., Rochester, MN

55901

(Address of principal executive offices)

(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 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

Smaller reporting company

(Do not check if a 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 common stock as of the latest practicable date.

Class

Outstanding at October 10, 2008

Common stock, \$0.01 par value

4,167,630



**HMN FINANCIAL, INC.  
CONTENTS**

|   | Page |
|---|------|
| <b><u>PART I FINANCIAL INFORMATION</u></b>  |      |
| <b><u>Item 1: Financial Statements (unaudited)</u></b>  |      |
| <u>Consolidated Balance Sheets at September 30, 2008 and December 31, 2007</u>  | 3    |
| <u>Consolidated Statements of Income for the Three Months Ended and Nine Months Ended September 30, 2008 and 2007</u>             | 4    |
| <u>Consolidated Statement of Stockholders' Equity and Comprehensive Income for the Nine Month Period Ended September 30, 2008</u> | 5    |
| <u>Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2008 and 2007</u>                                | 6    |
| <u>Notes to Consolidated Financial Statements</u>   | 7    |
| <b><u>Item 2: Management's Discussion and Analysis of Financial Condition and Results of Operations</u></b>                       | 14   |
| <b>Item 3: Quantitative and Qualitative Disclosures about Market Risk</b>   | 23   |
| <b><u>Item 4: Controls and Procedures</u></b>   | 25   |
| <b><u>PART II OTHER INFORMATION</u></b>   |      |
| <b><u>Item 1: Legal Proceedings</u></b>   | 26   |
| <b><u>Item 1A: Risk Factors</u></b>   | 26   |
| <b><u>Item 2: Unregistered Sales of Equity Securities and Use of Proceeds</u></b>   | 26   |
| <b><u>Item 3: Defaults Upon Senior Securities</u></b>   | 26   |
| <b><u>Item 4: Submission of Matters to a Vote of Security Holders</u></b>   | 26   |
| <b><u>Item 5: Other Information</u></b>   | 26   |
| <b><u>Item 6: Exhibits</u></b>  | 26   |
| <b><u>Signatures</u></b>  | 27   |
| <b><u>EXHIBIT 31.1</u></b>  |      |
| <b><u>EXHIBIT 31.2</u></b>  |      |
| <b><u>EXHIBIT 32</u></b>  |      |

**Table of Contents****PART I FINANCIAL STATEMENTS**

## Item 1: Financial Statements

**HMN FINANCIAL, INC. AND SUBSIDIARIES  
Consolidated Balance Sheets**

|   | September<br>30,<br>2008 | December<br>31,<br>2007 |
|---|--------------------------|-------------------------|
| <i>(dollars in thousands, except per share data)</i>  |                          |                         |
|   | (unaudited)              |                         |
| <b>Assets</b>   |                          |                         |
| Cash and cash equivalents   | \$ 17,220                | 23,718                  |
| Securities available for sale:  |                          |                         |
| Mortgage-backed and related securities (amortized cost \$75,496 and \$18,786)                       | 74,595                   | 18,468                  |
| Other marketable securities (amortized cost \$110,439 and \$165,430)                                | 111,463                  | 167,720                 |
|   | 186,058                  | 186,188                 |
| Loans held for sale   | 4,222                    | 3,261                   |
| Loans receivable, net   | 873,156                  | 865,088                 |
| Accrued interest receivable   | 5,211                    | 6,893                   |
| Real estate, net  | 8,798                    | 2,214                   |
| Federal Home Loan Bank stock, at cost   | 7,461                    | 6,198                   |
| Mortgage servicing rights, net  | 824                      | 1,270                   |
| Premises and equipment, net   | 13,442                   | 12,024                  |
| Goodwill  | 0                        | 3,801                   |
| Prepaid expenses and other assets   | 7,033                    | 1,680                   |
| Deferred tax assets, net  | 5,475                    | 4,719                   |
| Total assets  | \$ 1,128,900             | 1,117,054               |
| <b>Liabilities and Stockholders Equity</b>  |                          |                         |
| Deposits  | \$ 888,848               | 888,118                 |
| Federal Home Loan Bank advances   | 141,500                  | 112,500                 |
| Accrued interest payable  | 5,984                    | 9,515                   |
| Customer escrows  | 1,098                    | 866                     |
| Accrued expenses and other liabilities  | 4,894                    | 7,927                   |
| Total liabilities   | 1,042,324                | 1,018,926               |
| Commitments and contingencies   |                          |                         |
| Stockholders equity:  |                          |                         |
| Serial preferred stock: (\$.01 per value)<br>authorized 500,000 shares; issued and outstanding none | 0                        | 0                       |
| Common stock (\$.01 par value):<br>authorized 11,000,000; issued shares 9,128,662                   | 91                       | 91                      |
| Additional paid-in capital  | 57,962                   | 58,049                  |

Edgar Filing: HMN FINANCIAL INC - Form 10-Q

|  |              |           |
|--|--------------|-----------|
| Retained earnings, subject to certain restrictions     | 100,605      | 110,943   |
| Accumulated other comprehensive income                 | 73           | 1,167     |
| Unearned employee stock ownership plan shares          | (3,819)      | (3,965)   |
| Treasury stock, at cost 4,961,032 and 4,953,045 shares | (68,336)     | (68,157)  |
| Total stockholders' equity                             | 86,576       | 98,128    |
| Total liabilities and stockholders' equity             | \$ 1,128,900 | 1,117,054 |

See accompanying notes to consolidated financial statements.

3

---

**Table of Contents**

**HMN FINANCIAL, INC. AND SUBSIDIARIES**  
**Consolidated Statements of Income**  
(unaudited)

|   | Three Months Ended |               | Nine Months Ended |               |
|---|--------------------|---------------|-------------------|---------------|
|   | September 30,      |               | September 30,     |               |
| <i>(dollars in thousands except per share data)</i>               | 2008               | 2007          | 2008              | 2007          |
| Interest income:  |                    |               |                   |               |
| Loans receivable  | \$ 14,634          | 17,258        | 44,573            | 49,632        |
| Securities available for sale:                                    |                    |               |                   |               |
| Mortgage-backed and related                                       | 360                | 212           | 797               | 495           |
| Other marketable  | 1,224              | 2,498         | 4,641             | 6,810         |
| Cash equivalents  | 78                 | 250           | 196               | 972           |
| Other   | 78                 | 60            | 211               | 276           |
| <b>Total interest income</b>                                      | <b>16,374</b>      | <b>20,278</b> | <b>50,418</b>     | <b>58,185</b> |
| Interest expense:   |                    |               |                   |               |
| Deposits  | 6,235              | 9,283         | 20,944            | 24,506        |
| Federal Home Loan Bank advances                                   | 1,571              | 1,182         | 4,047             | 4,227         |
| <b>Total interest expense</b>                                     | <b>7,806</b>       | <b>10,465</b> | <b>24,991</b>     | <b>28,733</b> |
| Net interest income   | 8,568              | 9,813         | 25,427            | 29,452        |
| Provision for loan losses   | 15,790             | 921           | 18,480            | 2,404         |
| <b>Net interest income (loss) after provision for loan losses</b> | <b>(7,222)</b>     | <b>8,892</b>  | <b>6,947</b>      | <b>27,048</b> |
| Non-interest income:  |                    |               |                   |               |
| Fees and service charges  | 1,077              | 828           | 2,868             | 2,306         |
| Mortgage servicing fees   | 240                | 254           | 722               | 789           |
| Securities gains, net   | 479                | 0             | 479               | 0             |
| Gain on sales of loans  | 58                 | 205           | 442               | 1,189         |
| Other   | 99                 | 362           | 716               | 724           |
| <b>Total non-interest income</b>                                  | <b>1,953</b>       | <b>1,649</b>  | <b>5,227</b>      | <b>5,008</b>  |
| Non-interest expense:   |                    |               |                   |               |
| Compensation and benefits   | 3,010              | 3,147         | 9,406             | 9,770         |
| Occupancy   | 1,131              | 1,127         | 3,424             | 3,323         |
| Advertising   | 95                 | 123           | 311               | 424           |
| Data processing   | 399                | 325           | 1,077             | 941           |
| Amortization of mortgage servicing rights, net                    | 142                | 169           | 456               | 540           |
| Goodwill impairment charge  | 0                  | 0             | 3,801             | 0             |
| Other   | 1,784              | 1,062         | 4,139             | 3,054         |

Edgar Filing: HMN FINANCIAL INC - Form 10-Q

|   |            |       |          |        |
|---|------------|-------|----------|--------|
| Total non-interest expense                        | 6,561      | 5,953 | 22,614   | 18,052 |
| Income (loss) before income tax expense (benefit) | (11,830)   | 4,588 | (10,440) | 14,004 |
| Income tax expense (benefit)                      | (4,779)    | 1,806 | (2,851)  | 5,505  |
| Net income (loss)                                 | \$ (7,051) | 2,782 | (7,589)  | 8,499  |
| Basic earnings (loss) per share                   | \$ (1.93)  | 0.74  | (2.08)   | 2.26   |
| Diluted earnings (loss) per share                 | \$ (1.93)  | 0.71  | (2.08)   | 2.16   |

See accompanying notes to consolidated financial statements.

4

---



**Table of Contents**

**HMN FINANCIAL, INC. AND SUBSIDIARIES**  
**Consolidated Statement of Stockholders Equity and Comprehensive Income**  
**For the Nine-Month Period Ended September 30, 2008**  
(unaudited)

| <i>(dollars in thousands)</i>                          | Common<br>Stock | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Unearned<br>Employee<br>Stock<br>Ownership<br>Plan<br>Shares | Treasury<br>Stock | Stock-<br>Holders<br>Equity |
|--|-----------------|----------------------------------|----------------------|---|--|-------------------|-----------------------------|
| Balance, December 31, 2007                             | \$ 91           | 58,049                           | 110,943              | 1,167   | (3,965)  | (68,157)          | 98,128                      |
| Net loss   |                 |                                  | (7,589)              |   |  |                   | (7,589)                     |
| Other comprehensive loss, net of tax:                  |                 |                                  |                      |   |  |                   |                             |
| Net unrealized losses on securities available for sale |                 |                                  |                      | (1,094)   |  |                   | (1,094)                     |
| Total comprehensive loss                               |                 |                                  |                      |   |  |                   | (8,683)                     |
| Purchase of treasury stock                             |                 |                                  |                      |   |  | (723)             | (723)                       |
| Unearned compensation restricted stock awards          |                 | (550)                            |                      |   |  | 550               | 0                           |
| Restricted stock awards forfeited                      |                 | 6                                |                      |   |  | (6)               | 0                           |
| Stock compensation tax benefits                        |                 | 25                               |                      |   |  |                   | 25                          |
| Amortization of restricted stock awards                |                 | 310                              |                      |   |  |                   | 310                         |
| Dividends paid   |                 |                                  | (2,749)              |   |  |                   | (2,749)                     |
| Earned employee stock ownership plan shares            |                 | 122                              |                      |   | 146  |                   | 268                         |
| Balance, September 30, 2008                            | \$ 91           | 57,962                           | 100,605              | 73  | (3,819)  | (68,336)          | 86,576                      |

See accompanying notes to consolidated financial statements.

**Table of Contents**

**HMN FINANCIAL, INC. AND SUBSIDIARIES**  
**Consolidated Statements of Cash Flows**  
(unaudited)

|  | Nine Months Ended<br>September 30, |               |
|--|------------------------------------|---------------|
|  | 2008                               | 2007          |
| <i>(dollars in thousands)</i>  |                                    |               |
| Cash flows from operating activities:  |                                    |               |
| Net income (loss)  | \$ (7,589)                         | 8,499         |
| Adjustments to reconcile net income (loss) to cash provided by operating activities: |                                    |               |
| Provision for loan losses  | 18,480                             | 2,404         |
| Depreciation   | 1,288                              | 1,429         |
| Amortization of (discounts) premiums, net  | 101                                | (2,183)       |
| Amortization of deferred loan fees   | (616)                              | (997)         |
| Amortization of core deposit intangible  | 0                                  | 85            |
| Amortization of mortgage servicing rights  | 456                                | 540           |
| Capitalized mortgage servicing rights  | (10)                               | (13)          |
| Securities gains, net  | (479)                              | 0             |
| Loss (gain) on sales of real estate  | (160)                              | 35            |
| Gain on sales of loans   | (442)                              | (1,189)       |
| Proceeds from sales of real estate   | 6,046                              | 4,903         |
| Proceeds from sales of loans held for sale   | 47,640                             | 51,215        |
| Disbursements on loans held for sale   | (45,914)                           | (39,470)      |
| Amortization of restricted stock awards  | 310                                | 251           |
| Amortization of unearned ESOP shares   | 146                                | 146           |
| Earned employee stock ownership shares priced above original cost                    | 122                                | 274           |
| Stock option compensation  | 25                                 | 32            |
| (Increase) decrease in accrued interest receivable                                   | 1,682                              | (2,289)       |
| (Decrease) increase in accrued interest payable                                      | (3,531)                            | 6,651         |
| Goodwill impairment charge   | 3,801                              | 0             |
| (Increase) decrease in other assets  | (5,371)                            | 1,034         |
| (Decrease) increase in other liabilities   | (3,091)                            | 1,126         |
| Other, net   | 25                                 | 13            |
| <br>Net cash provided by operating activities  | <br>12,919                         | <br>32,496    |
| Cash flows from investing activities:  |                                    |               |
| Proceeds from sales of securities available for sale                                 | 10,442                             | 0             |
| Principal collected on securities available for sale                                 | 2,872                              | 1,677         |
| Proceeds collected on maturities of securities available for sale                    | 85,000                             | 120,000       |
| Purchases of securities available for sale   | (99,442)                           | (203,067)     |
| Purchase of Federal Home Loan Bank stock   | (5,959)                            | (999)         |
| Redemption of Federal Home Loan Bank stock   | 4,696                              | 3,375         |
| Net increase in loans receivable   | (40,579)                           | (96,004)      |
| Purchases of premises and equipment  | (2,725)                            | (2,136)       |
| <br>Net cash used by investing activities  | <br>(45,695)                       | <br>(177,154) |
| Cash flows from financing activities:  |                                    |               |

Edgar Filing: HMN FINANCIAL INC - Form 10-Q

|  |           |           |
|--|-----------|-----------|
| Increase in deposits   | 518       | 210,923   |
| Purchase of treasury stock                                   | (723)     | (2,778)   |
| Stock options exercised                                      | 0         | 139       |
| Excess tax benefits from options exercised                   | 0         | 99        |
| Dividends to stockholders                                    | (2,749)   | (2,813)   |
| Proceeds from borrowings                                     | 347,700   | 114,100   |
| Repayment of borrowings                                      | (318,700) | (167,500) |
| Increase in customer escrows                                 | 232       | 628       |
| <br>   |           |           |
| Net cash provided by financing activities                    | 26,278    | 152,798   |
| <br>   |           |           |
| Increase (decrease) in cash and cash equivalents             | (6,498)   | 8,140     |
| Cash and cash equivalents, beginning of period               | 23,718    | 43,776    |
| <br>   |           |           |
| Cash and cash equivalents, end of period                     | \$ 17,220 | 51,916    |
| <br>   |           |           |
| Supplemental cash flow disclosures:                          |           |           |
| Cash paid for interest                                       | \$ 28,522 | 22,083    |
| Cash paid for income taxes                                   | 5,247     | 5,482     |
| Supplemental noncash flow disclosures:                       |           |           |
| Transfer of loans to real estate                             | 12,476    | 5,388     |
| Loans transferred to loans held for sale                     | 2,170     | 11,239    |
| See accompanying notes to consolidated financial statements. |           |           |

**Table of Contents**

**HMN FINANCIAL, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements**  
(unaudited)  
**September 30, 2008 and 2007**

***(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 acts as an intermediary for the Bank in transacting like-kind property exchanges for Bank customers.

The consolidated financial statements included herein are for HMN, SFC, the Bank and the Bank's wholly owned subsidiary, 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 income, consolidated statement of stockholders' equity and comprehensive income 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 consolidated statement of income for the nine-month period ended September 30, 2008 is not necessarily indicative of the results which may be expected for the entire year.

Certain amounts in the consolidated financial statements for prior periods have been reclassified to conform with the current period presentation.

***(3) New Accounting Standards***

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51*. This Statement amends *ARB No. 51* to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. It clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity and is reported as equity in the consolidated financial statements. This Statement applies to all for-profit entities that prepare consolidated financial statements, but affects only those entities that have an outstanding noncontrolling interest in subsidiaries or that deconsolidate a subsidiary. Since the Company has no noncontrolling interests in subsidiaries, the impact of adopting SFAS No. 160 on January 1, 2009 is not anticipated to have a material impact on the Company's consolidated financial statements.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations*. This Statement replaces SFAS No. 141, *Business Combinations* and retains the fundamental requirements in SFAS No. 141 that the purchase method of accounting be used for all business combinations and for an acquirer to be identified for each business combination. This Statement establishes principles and requirements for how the acquirer recognizes and measures the assets acquired (including goodwill), the liabilities assumed, and any controlling interest in the acquiree. It also determines what information is to be disclosed to enable users of the financial statement to evaluate the nature and financial effect of the business combination. The impact of adopting SFAS No. 141 (revised 2007) on January 1, 2009 is not anticipated to have a material impact on the Company's consolidated financial statements.

**Table of Contents**

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities-an amendment of FASB Statement No. 133*. This Statement applies to all entities and requires enhanced disclosures about an entity's derivative and hedging activities including how and why an entity uses derivative instruments, how derivative instruments and related hedged items are accounted for under Statement 133, and how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. The impact of adopting SFAS No. 161 on January 1, 2009 is not anticipated to have a material impact on the Company's consolidated financial statements.

In May 2008, the FASB issued SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles*. This Statement identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statement of nongovernmental entities that are presented in conformity with generally accepted accounting principles in the United States. This Statement is effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board amendments to AU Section 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles* and is not anticipated to have any impact on the Company's consolidated financial statements.

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

The Company has commitments outstanding to extend credit to future borrowers that had 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 or purchase 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, 2008, the Company recorded an increase in other liabilities of \$57,000 and a loss included in the gain on sales of loans of \$57,000.

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 a decrease in loans held for sale of \$17,000 and an increase in other assets of \$17,000 due to the mark to market adjustment on the commitments to sell loans held for sale.

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

On January 1, 2008, the Company adopted SFAS No. 157, *Fair Value Measurements*. SFAS No. 157 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.

**Table of Contents**

The following table summarizes the assets of the Company for which fair values are determined on a recurring basis as of September 30, 2008.

| <i>(Dollars in thousands)</i> | Carrying value at September 30, 2008 |         |         |         |
|-------------------------------|--------------------------------------|---------|---------|---------|
|                               | Total                                | Level 1 | Level 2 | Level 3 |
| Securities available for sale | \$ 186,058                           | 12,848  | 173,210 | 0       |
| Mortgage loan commitments     | (74)                                 | 0       | (74)    | 0       |
| Total                         | \$ 185,985                           | 12,848  | 173,137 | 0       |

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 2008 that were still held at September 30, 2008, 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, 2008.

| <i>(Dollars in thousands)</i>   | Carrying value at September 30, 2008 |         |         |         | Nine months ended<br>September 30,<br>2008<br>Total gains<br>(losses) |
|---------------------------------|--------------------------------------|---------|---------|---------|---|
|                                 | Total                                | Level 1 | Level 2 | Level 3 |   |
| Loans held for sale             | \$ 4,222                             | 0       | 4,222   | 0       | (15)  |
| Mortgage servicing rights       | 824                                  | 0       | 824     | 0       | 2,275   |
| Loans <sup>(1)</sup>            | 42,315                               | 0       | 42,315  | 0       | (4,134)   |
| Real estate, net <sup>(2)</sup> | 8,798                                | 0       | 8,798   | 0       | (65)  |
| Total                           | \$ 56,159                            | 0       | 56,159  | 0       | (1,939)   |

(1) Represents 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) 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 is the total of net income and other comprehensive income, which for the Company is comprised of unrealized gains and losses on securities available for sale. The components of other comprehensive income and the related tax effects were as follows:

| <i>(Dollars in thousands)</i>                             | For the three months ended September 30, |            |            |            |            |            |
|---|--|------------|------------|------------|------------|------------|
|   |  | 2008       |            |            | 2007       |            |
|   | 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   | \$ (694)                                 | (310)      | (384)      | 1,796      | 712        | 1,084      |
| Less reclassification of net gains included in net income | 479                                      | 169        | 310        | 0          | 0          | 0          |
| Other comprehensive income (loss)                         | \$ (1,173)                               | (479)      | (694)      | 1,796      | 712        | 1,084      |

|   | For the nine months ended September 30, |            |            |            |            |            |
|---|---|------------|------------|------------|------------|------------|
|   |   | 2008       |            |            | 2007       |            |
|   | 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   | \$ (1,370)                              | (586)      | (784)      | 927        | 368        | 559        |
| Less reclassification of net gains included in net income | 479                                     | 169        | 310        | 0          | 0          | 0          |
| Other comprehensive income (loss)                         | \$ (1,849)                              | (755)      | (1,094)    | 927        | 368        | 559        |

**Table of Contents****(7) Securities Available For Sale**

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, 2008.

|                                       | Less than twelve months |            |                   | Twelve months or more |            |                   | Total      |                   |
|---------------------------------------|-------------------------|------------|-------------------|-----------------------|------------|-------------------|------------|-------------------|
|                                       | # of Investments        | Fair Value | Unrealized Losses | # of Investments      | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| <i>(Dollars in thousands)</i>         |                         |            |                   |                       |            |                   |            |                   |
| Mortgage backed securities:           |                         |            |                   |                       |            |                   |            |                   |
| FHLMC                                 | 11                      | \$31,226   | (332)             | 1                     | \$2,454    | (398)             | \$33,680   | (730)             |
| FNMA                                  | 8                       | 22,408     | (245)             | 3                     | 2,575      | (137)             | 24,983     | (382)             |
| Other marketable securities:          |                         |            |                   |                       |            |                   |            |                   |
| FNMA Notes                            | 4                       | 20,080     | (45)              |                       |            |                   | 20,080     | (45)              |
| Corporate equity                      | 1                       | 350        | (350)             |                       |            |                   | 350        | (350)             |
| Total temporarily impaired securities | 24                      | \$74,064   | (972)             | 4                     | \$5,029    | (535)             | \$79,093   | (1,507)           |

These investments are temporarily impaired due to changes in interest rates and the Company has the intent and ability to hold to maturity or until the temporary loss is recovered. Mortgage backed securities in the table above had an average remaining life of less than eight years and the other marketable securities had an average remaining life of less than three years at September 30, 2008.

**(8) Mortgage Servicing Rights**

A summary of mortgage servicing activity is as follows:

|   | Nine Months ended<br>Sept. 30, 2008 | Twelve Months ended<br>Dec. 31, 2007 | Nine Months ended<br>Sept. 30, 2007 |
|---|-------------------------------------|--------------------------------------|-------------------------------------|
| <i>(Dollars in thousands)</i>           |                                     |                                      |                                     |
| Mortgage servicing rights               |                                     |                                      |                                     |
| Balance, beginning of period            | \$ 1,270                            | 1,958                                | 1,958                               |
| Originations                            | 10                                  | 18                                   | 13                                  |
| Amortization                            | (456)                               | (706)                                | (540)                               |
| Balance, end of period                  | 824                                 | 1,270                                | 1,431                               |
| Fair value of mortgage servicing rights | \$ 3,099                            | 3,261                                | 3,703                               |

All of the loans being serviced were single-family loans serviced for FNMA under the mortgage-backed security program or individual loan sale program. The following is a summary of the risk characteristics of the loans being serviced at September 30, 2008.

|                                  | Loan Principal Balance | Weighted Average Interest Rate | Weighted Average Remaining Term | Number of Loans |
|----------------------------------|------------------------|--------------------------------|---------------------------------|-----------------|
| <i>(Dollars in thousands)</i>    |                        |                                |                                 |                 |
| Original term 30 year fixed rate | \$198,546              | 5.87%                          | 285 mos.                        | 1,863           |
| Original term 15 year fixed rate | 103,635                | 5.17%                          | 107 mos.                        | 1,699           |



Edgar Filing: HMN FINANCIAL INC - Form 10-Q

|                 |       |       |          |    |
|-----------------|-------|-------|----------|----|
| Adjustable rate | 1,896 | 5.92% | 294 mos. | 18 |
|-----------------|-------|-------|----------|----|

The gross carrying amount of mortgage servicing rights and the associated accumulated amortization at September 30, 2008 is presented in the following table. Amortization expense for mortgage servicing rights was \$456,000 and \$540,000 for the nine months ended September 30, 2008 and 2007, respectively.

**Table of Contents**

| <i>(Dollars in thousands)</i> | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Unamortized<br>Intangible<br>Assets |
|-------------------------------|-----------------------------|-----------------------------|-------------------------------------|
| Amortized intangible assets:  |                             |                             |                                     |
| Mortgage servicing rights     | \$ 3,861                    | (3,037)                     | 824                                 |
| Total                         | \$ 3,861                    | (3,037)                     | 824                                 |

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

| <i>(Dollars in thousands)</i>    | Mortgage<br>Servicing<br>Rights |
|----------------------------------|---------------------------------|
| Year ending December 31,<br>2008 | \$ 117                          |
| 2009                             | 362                             |
| 2010                             | 198                             |
| 2011                             | 96                              |
| 2012                             | 38                              |

Projections of amortization are based on existing asset balances and the existing interest rate environment as of September 30, 2008. The Company's actual experience may be significantly different depending upon changes in mortgage interest rates and other market conditions.

**(9) Earnings (loss) per Share**

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

|  | Three months ended<br>September 30, |       | Nine months ended<br>September 30, |       |
|--|-------------------------------------|-------|------------------------------------|-------|
|  | 2008                                | 2007  | 2008                               | 2007  |
| Weighted average number of common shares<br>outstanding used in basic earnings per common<br>share calculation | 3,657                               | 3,738 | 3,651                              | 3,756 |
| Net dilutive effect of:  |                                     |       |                                    |       |
| Options  | 0                                   | 143   | 0                                  | 158   |
| Restricted stock awards  | 0                                   | 17    | 0                                  | 19    |
| Weighted average number of shares<br>outstanding adjusted for effect of dilutive<br>securities                 | 3,657                               | 3,898 | 3,651                              | 3,933 |
| Income (loss) available to common<br>shareholders  | \$ (7,051)                          | 2,782 | (7,589)                            | 8,499 |
| Basic earnings (loss) per common share   | \$ (1.93)                           | 0.74  | (2.08)                             | 2.26  |
| Diluted earnings (loss) per common share   | \$ (1.93)                           | 0.71  | (2.08)                             | 2.16  |

**(10) Regulatory Capital**

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.

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 or Core capital and Risk-based capital (as defined in the regulations) to total assets (as defined). Management believes, as of September 30, 2008, that the Bank meets all capital adequacy requirements to which it is subject.

**Table of Contents**

Management believes that based upon the Bank's capital calculations at September 30, 2008 and other conditions consistent with the Prompt Corrective Actions Provisions of the OTS regulations, the Bank would be categorized as well capitalized.

On September 30, 2008, the Bank's tangible assets and adjusted total assets were \$1.13 billion and its risk-weighted assets were \$867.8 million. The following table presents the Bank's capital amounts and ratios at September 30, 2008 for actual capital, required capital and excess capital including ratios required to qualify as a well capitalized institution under the Prompt Corrective Actions regulations.

|   | Actual    |                                  | Required to be Adequately Capitalized |                                  | Excess Capital |                                  | To Be Well Capitalized Under Prompt Corrective Action 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> |
| <i>(Dollars in thousands)</i>                                 |           |                                  |                                       |                                  |                |                                  |  |                                  |
| Bank stockholder's equity                                     | \$ 82,925 |                                  |                                       |                                  |                |                                  |  |                                  |
| Less:   |           |                                  |                                       |                                  |                |                                  |  |                                  |
| Net unrealized gains on certain securities available for sale | (278)     |                                  |                                       |                                  |                |                                  |  |                                  |
| Tier I or core capital  | 82,647    |                                  |                                       |                                  |                |                                  |  |                                  |
| Tier I capital to adjusted total assets                       |           | 7.33%                            | \$ 45,129                             | 4.00%                            | \$ 37,518      | 3.33%                            | \$ 56,411  | 5.00%                            |
| Tier I capital to risk-weighted assets                        |           | 9.52%                            | \$ 34,712                             | 4.00%                            | \$ 47,935      | 5.52%                            | \$ 52,069  | 6.00%                            |
| Plus:   |           |                                  |                                       |                                  |                |                                  |  |                                  |
| Allowable allowance for loan losses                           | 8,849     |                                  |                                       |                                  |                |                                  |  |                                  |
| Risk-based capital  | \$ 91,496 |                                  | \$ 69,425                             |                                  | \$ 22,071      |                                  | \$ 86,781  |                                  |
| Risk-based capital to risk-weighted assets                    |           | 10.54%                           |                                       | 8.00%                            |                | 2.54%                            |  | 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.

**(11) Commitments and Contingencies**

The Bank issued standby letters of credit which guarantee the performance of customers to third parties. The standby letters of credit outstanding at September 30, 2008 were approximately \$7.9 million, expire over the next two years and are collateralized primarily with commercial real estate mortgages. 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.

In February 2007, the Minnesota Department of Revenue (MDR) assessed a deficiency of \$2.2 million against the Company's 2002 through 2004 Minnesota state tax payments. The deficiency relates to the tax treatment of the inter-company dividends paid to the Bank by a former subsidiary of the Company. The Company filed a Notice of Appeal in the Minnesota Tax Court challenging that assessment and a hearing has been scheduled for the fourth quarter of 2008. If the assessment challenge is not successful, the Company could potentially record a net increase income tax expense of up to \$1.1 million after considering federal income tax deductions and previously recorded contingency accruals.

**(12) Business Segments**

The Bank has been identified as a reportable operating segment in accordance with the provisions of SFAS No. 131. SFC and HMN, the holding company, did not meet the quantitative thresholds for a reportable segment 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.

**Table of Contents**

The following table sets forth certain information about the reconciliations of reported net income and assets for each of the Company's reportable segments.

| <i>(Dollars in thousands)</i>                              | Home<br>Federal |         |              | Consolidated |
|--|-----------------|---------|--------------|--------------|
|  | Savings Bank    | Other   | Eliminations | Total        |
| <b>At or for the quarter ended September 30, 2008:</b>     |                 |         |              |              |
| Interest income external customers                         | \$ 16,372       | 2       | 0            | 16,374       |
| Non-interest income external customers                     | 1,958           | 0       | 0            | 1,958        |
| Loss on limited partnerships                               | (5)             | 0       | 0            | (5)          |
| Intersegment interest income                               | 0               | 18      | (18)         | 0            |
| Intersegment non-interest income                           | 44              | (6,952) | 6,908        | 0            |
| Interest expense   | 7,824           | 0       | (18)         | 7,806        |
| Amortization of mortgage servicing rights, net             | 142             | 0       | 0            | 142          |
| Other non-interest expense                                 | 6,276           | 187     | (44)         | 6,419        |
| Income tax benefit   | (4,713)         | (66)    | 0            | (4,779)      |
| Net loss   | (6,951)         | (7,052) | 6,952        | (7,051)      |
| Goodwill   | 0               | 0       | 0            | 0            |
| Total assets   | 1,128,029       | 87,461  | (86,590)     | 1,128,900    |
| <b>At or for the quarter ended September 30, 2007:</b>     |                 |         |              |              |
| Interest income external customers                         | \$ 20,276       | 2       | 0            | 20,278       |
| Non-interest income external customers                     | 1,554           | 100     | 0            | 1,654        |
| Loss on limited partnerships                               | (5)             | 0       | 0            | (5)          |
| Intersegment interest income                               | 0               | 27      | (27)         | 0            |
| Intersegment non-interest income                           | 44              | 2,821   | (2,865)      | 0            |
| Interest expense   | 10,492          | 0       | (27)         | 10,465       |
| Amortization of mortgage servicing rights, net             | 169             | 0       | 0            | 169          |
| Other non-interest expense                                 | 5,634           | 194     | (44)         | 5,784        |
| Income tax expense (benefit)                               | 1,832           | (26)    | 0            | 1,806        |
| Net income   | 2,821           | 2,782   | (2,821)      | 2,782        |
| Goodwill   | 3,801           | 0       | 0            | 3,801        |
| Total assets   | 1,142,558       | 97,981  | (93,126)     | 1,147,413    |
| <b>At or for the nine months ended September 30, 2008:</b> |                 |         |              |              |
| Interest income external customers                         | \$ 50,402       | 16      | 0            | 50,418       |
| Non-interest income external customers                     | 5,231           | 0       | 0            | 5,231        |
| Loss on limited partnerships                               | (4)             | 0       | 0            | (4)          |
| Intersegment interest income                               | 0               | 69      | (69)         | 0            |
| Intersegment non-interest income                           | 131             | (7,319) | 7,188        | 0            |
| Interest expense   | 25,060          | 0       | (69)         | 24,991       |
| Amortization of mortgage servicing rights, net             | 456             | 0       | 0            | 456          |
| Other non-interest expense                                 | 21,745          | 544     | (131)        | 22,158       |
| Income tax benefit   | (2,666)         | (185)   | 0            | (2,851)      |
| Net loss   | (7,315)         | (7,593) | 7,319        | (7,589)      |
| Goodwill   | 0               | 0       | 0            | 0            |
| Total assets   | 1,128,029       | 87,461  | (86,590)     | 1,128,900    |
| <b>At or for the nine months ended September 30, 2007:</b> |                 |         |              |              |

Edgar Filing: HMN FINANCIAL INC - Form 10-Q

|  |           |        |          |           |
|--|-----------|--------|----------|-----------|
| Interest income external customers             | \$ 58,145 | 40     | 0        | 58,185    |
| Non-interest income external customers         | 4,913     | 100    | 0        | 5,013     |
| Loss on limited partnerships                   | (5)       | 0      | 0        | (5)       |
| Intersegment interest income                   | 0         | 85     | (85)     | 0         |
| Intersegment non-interest income               | 131       | 8,687  | (8,818)  | 0         |
| Interest expense                               | 28,818    | 0      | (85)     | 28,733    |
| Amortization of mortgage servicing rights, net | 540       | 0      | 0        | 540       |
| Other non-interest expense                     | 17,090    | 553    | (131)    | 17,512    |
| Income tax expense                             | 5,642     | (137)  | 0        | 5,505     |
| Net income                                     | 8,690     | 8,496  | (8,687)  | 8,499     |
| Goodwill                                       | 3,801     | 0      | 0        | 3,801     |
| Total assets                                   | 1,142,558 | 97,981 | (93,126) | 1,147,413 |

13

**Table of Contents****HMN FINANCIAL, INC.****Item 2: 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 that deal with future results, plans or performance. In addition, the Company's management may make such statements orally to the media, or to securities analysts, investors or others. Forward-looking statements deal with matters that do not relate strictly to historical facts. Words such as anticipate, believe, expect, intend, would, could, estimate, project and similar expressions, as they relate to us, are intended to identify such forward-looking statements. The Company's future results may differ materially from historical performance and forward-looking statements about the Company's expected financial results or other plans are subject to a number of risks and uncertainties. These statements include, but are not limited to those relating to expectations regarding additional losses due to apparent fraud related to Petters Company, Inc. (PCI), the potential for recoveries on the loan that is the subject of the apparent fraud related to PCI, the adequacy of available liquidity to the Bank, the Company's potential participation in the Capital Purchase Program of the United States Treasury Department, the future outlook for the Company, the result of actions being taken by national and world leaders stabilizing the global economy and assuring consumer and business access to credit, any future dividends, and the Company's financial expectations for earnings and interest income. 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 securing loans to borrowers connected with PCI, the Company's eligibility to participate in the Capital Purchase Program, possible legislative and regulatory changes and adverse economic, business and competitive developments such as shrinking interest margins; reduced collateral values; deposit outflows; 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, changes in credit or other risks posed by the Company's loan and investment portfolios; technological, computer-related or operational difficulties; adverse changes in securities markets; results of litigation 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 filings on Form 10-K with the Securities and Exchange Commission. 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 section of the Company's Annual Report on Form 10-K for the year ended December 31, 2007 and Part II, Item 1A of this quarterly report 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 and Federal Home Loan Bank (FHLB) advances. 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 and valuation adjustments on mortgage servicing assets. The increased emphasis on commercial real estate and single family residential development loans over the past several years has increased the credit risk inherent in the loan portfolio and the provision for loan losses has increased due to commercial loan charge offs and risk rating downgrades as a result of a decrease in the demand for housing and building lots.



**Table of Contents**

The earnings of financial institutions, such as the Bank, are 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 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. The interest rates charged by the FHLB and Federal Reserve Bank (FRB) on advances to the Bank also have a significant impact on the Bank's overall cost of funds.

***Outlook***

(The following are forward-looking statements; see *Forward-looking information* at the beginning of this section) The Company's management has identified a number of factors which may affect the Company's operations and results in the future. They are as follows:

The recent general economic slowdown, and the softness and declines in the real estate market, may continue. If that is the case, there are a number of adverse effects that we, like other financial institutions, would likely experience such as:

Loan originations could continue to fluctuate from period to period, along with related interest and fee income.

A continuing decrease in the value of real estate may occur. Reduced property prices and a soft real estate market could negatively affect the volume of home sales, which, in turn, could affect the construction, residential development, mortgage and home equity loan originations and prepayments.

A continuation of soft or declining real estate values could also affect the value of the collateral securing our construction, development and mortgage loans. A decrease in value could, in turn, lead to increased losses on loans in the event of foreclosures, which would affect our provisions for loan losses and profitability.

A general slowdown in the economy or a recession may affect our borrowers' ability to repay their loan obligations, which could lead to increased charge-offs and loan loss provisions and/or less revenue.

If customer demand for real estate loans decreases, our profits may decrease because our investments, primarily mortgage-related securities, generally earn less income than real estate loans.

The current unsettled markets may also affect the liquidity and/or value of our real estate-related investments. We will continue to originate commercial real estate and commercial business loans, both of which can present a higher risk than residential mortgages. Adding personnel to continue to originate these loans in the current environment will increase our costs. However, market conditions and other factors may continue to affect our ability to increase our loan portfolio with these types of loans, and a weak economy could increase the risk that borrowers will not be able to repay these loans.

***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. The Company has identified the following policies as being critical because they require difficult, subjective, and/or complex judgments that are inherently uncertain. Therefore, actual financial results could differ significantly depending upon the estimates 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 construction permits, development plans, local economic growth rates, historical experience and observations made by the Company's ongoing internal audit and regulatory exam processes.

**Table of Contents**

Loans are charged off to the extent they are deemed to be uncollectible. The Company has established separate components of its overall methodology to determine the adequacy 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 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 using a combination of the Company's own loss experience and external industry data and are generally assigned to all loans that are on performing status. The Company also performs an individual analysis of impairment on each non-performing loan that is based on the expected cash flows or the value of the assets collateralizing the loans. 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 adequacy 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. 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 specific reserves are not required. Although management believes that based on current conditions the allowance for loan losses is maintained at an adequate amount to provide for probable loan losses inherent in the portfolio as of the balance sheet dates, future conditions may differ substantially from those anticipated in determining the allowance for loan losses and adjustments may be required in the future.

*Mortgage Servicing Rights*

The Company recognizes as an asset the rights to service mortgage loans for others, which are referred to as mortgage servicing rights (MSRs). MSRs are capitalized at the fair value of the servicing rights on the date the mortgage loan is sold and are carried at the lower of the capitalized amount, net of accumulated amortization, or fair value. MSRs are capitalized and amortized in proportion to, and over the period of, estimated net servicing income. Each quarter the Company evaluates its MSRs for impairment in accordance with Statement of Financial Accounting Standards (SFAS) No. 140. Loan type and interest rate are the predominant risk characteristics of the underlying loans used to stratify the MSRs for purposes of measuring impairment. If temporary impairment exists, a valuation allowance is established for any excess of amortized cost over the current fair value through a charge to income. If the Company later determines that all or a portion of the temporary impairment no longer exists, a reduction of the valuation allowance is recorded as an increase to income. The valuation is based on various assumptions, including the estimated prepayment speeds and default rates of the stratified portfolio. Changes in the mix of loans, interest rates, prepayment speeds, or default rates from the estimates used in the valuation of the mortgage servicing rights may have a material effect on the amortization and valuation of MSRs. Management believes that the assumptions used and the values determined are reasonable based on current conditions. However, future economic conditions may differ substantially from those anticipated in determining the value of the MSRs and adjustments may be required in the future. The Company does not formally hedge its MSRs because they are hedged naturally by the Company's origination volume. Generally, as interest rates rise the origination volume declines and the value of MSRs increases and as interest rates decline the origination volume increases and the value of MSRs decreases.

*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

**Table of Contents**

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 adopted FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109* (FIN 48) on January 1, 2007. FIN 48 requires the use of estimates and management's best judgment to determine the amounts and probabilities of all of the possible outcomes that could be realized upon the ultimate settlement of a tax position using the facts, circumstances, and information available. The application of FIN 48 requires significant judgment in arriving at the amount of tax benefits to be recognized in the financial statements for a given tax position. 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.

***Net Income (Loss)***

The Company's net loss was \$7.1 million for the third quarter of 2008, a \$9.9 million decrease from net income of \$2.8 million for the third quarter of 2007. Diluted loss per common share for the third quarter of 2008 was \$1.93, down \$2.64 from diluted earnings per share of \$0.71 for the third quarter of 2007. The decrease in net income for the quarter is due primarily to a \$14.9 million increase in the loan loss provision between the periods as a result of increased commercial loan charge offs. In the third quarter of 2008, the Bank recorded a loan loss provision of \$12.0 million related indirectly to the charges of fraud against businessman Tom Petters and the bankruptcy of Petters Company, Inc. (PCI). The Bank issued a commercial loan in April 2003 to a company that in turn loaned money to PCI. The Bank took a security interest in receivables from PCI as collateral for its commercial loan. It now appears that fraudulent misrepresentations were made about the collateral. The loan in question was current prior to the discovery of the apparent fraud, which remains under investigation. The financial capability of the borrower to repay the loan is uncertain due to the pervasive impact that the apparent fraud has had on the borrower's financial position, which raises substantial doubt regarding future collections on the loan. Accordingly, the Bank has recorded a provision for loan losses and a corresponding charge-off of \$12.0 million in the third quarter of 2008 relating to this loan. The Bank has additional outstanding loans to borrowers connected with PCI. However, the additional loans are secured by real estate and the Bank currently does not expect any additional losses due to the apparent fraud related to PCI.

The net loss was \$7.6 million for the nine-month period ended September 30, 2008, a decrease of \$16.0 million compared to net income of \$8.5 million for the nine-month period ended September 30, 2007. Diluted loss per common share for the nine-month period in 2008 was (\$2.08), down \$4.24 from \$2.16 of diluted earnings per share for the same period in 2007. The decrease in net income for the first nine months of 2008 is primarily due to a \$16.1 million increase in the loan loss provision between the periods as a result of increased commercial loan charge offs. Included in the \$16.1 million loan loss provision is the \$12.0 million charge off previously discussed related to fraudulent activities related to the collateral of one loan. Net income was also adversely affected by a \$3.8 million non-cash goodwill impairment charge and a \$4.0 million decrease in net interest income in the first nine-months of 2008 when compared to the same period in 2007.

***Net Interest Income***

Net interest income was \$8.6 million for the third quarter of 2008, a decrease of \$1.2 million, or 12.7%, compared to \$9.8 million for the third quarter of 2007. Interest income was \$16.4 million for the third quarter of 2008, a decrease of \$3.9 million, or 19.3%, from \$20.3 million for the same period in 2007. Interest income decreased primarily because of a decrease in the average yields earned on loans and investments. The decreased average yields were the result of the 275 basis point decrease in the prime interest rate between the periods. Decreases in the prime rate, which is the rate that banks charge their prime business customers, generally decrease the rates on adjustable rate consumer and commercial loans in the portfolio and on new loans originated. Interest income was also adversely affected by the increase in non-performing loans between the periods. The average yield earned on interest-earning assets was 6.14% for the third quarter of 2008, a decrease of 125 basis points from the 7.39% average yield for the third quarter of 2007.



**Table of Contents**

Interest expense was \$7.8 million for the third quarter of 2008, a decrease of \$2.7 million, or 25.4%, compared to \$10.5 million for the third quarter of 2007. Interest expense decreased primarily because of the lower interest rates paid on money market accounts and certificates of deposits. The decreased rates were the result of the 275 basis point decrease in the federal funds rate that occurred between the periods. Decreases in the federal funds rate, which is the rate that banks charge other banks for short term loans, generally have a lagging effect and decrease the rates banks pay for deposits. The lagging effect of deposit rate changes is primarily due to the Bank's deposits that are in the form of certificates of deposit which do not re-price immediately when the federal funds rate changes. The average interest rate paid on interest bearing liabilities was 3.12% for the third quarter of 2008, a decrease of 93 basis points from the 4.05% average rate paid in the third quarter of 2007.

Net interest margin (net interest income divided by average interest earning assets) for the third quarter of 2008 was 3.21%, a decrease of 37 basis points, compared to 3.58% for the third quarter of 2007.

Net interest income was \$25.4 million for the first nine months of 2008, a decrease of \$4.0 million, or 13.7%, from \$29.4 million for the same period in 2007. Interest income was \$50.4 million for the nine-month period ended September 30, 2008, a decrease of \$7.8 million, or 13.3%, from \$58.2 million for the same period in 2007. Interest income decreased primarily because of a decrease in the average yields earned on loans and investments. The decreased average yields were the result of the 275 basis point decrease in the prime interest rate between the periods. Decreases in the prime rate generally decrease the rates on adjustable rate consumer and commercial loans in the portfolio and on new loans originated. Interest income was also adversely affected by the increase in non-performing loans between the periods. The average yield earned on interest-earning assets was 6.37% for the first nine-months of 2008, a decrease of 108 basis points from the 7.45% average yield for the same period of 2007.

Interest expense was \$25.0 million for the nine-month period ended September 30, 2008, a decrease of \$3.7 million, or 13.0%, from \$28.7 million for the same period in 2007. Interest expense decreased primarily because of the lower interest rates paid on money market accounts and certificates of deposits. The decreased rates were the result of the 275 basis point decrease in the federal funds rate that occurred between the periods. Decreases in the federal funds rate generally have a lagging effect and decrease the rates banks pay for deposits. The lagging effect of deposit rate changes is because many of the Bank's deposits are in the form of certificates of deposit which do not re-price immediately when the federal funds rate changes. The average outstanding brokered deposit balance increased \$84.0 million between the periods primarily because brokered deposits were used to replace scheduled escrowed money market withdrawals. The average interest rate paid on interest bearing liabilities was 3.38% for the first nine months of 2008, a decrease of 52 basis points from the 3.90% average rate paid in the same period of 2007.

Net interest margin (net interest income divided by average interest earning assets) for the first nine months of 2008 was 3.21%, a decrease of 56 basis points, compared to 3.77% for the first nine months of 2007.

**Table of Contents**

A summary of the Company net interest margin for the nine month period ended September 30, 2008 and September 30, 2007 is as follows:

|  | For the nine month period ended |                       |              |                             |                       |              |
|--|---------------------------------|-----------------------|--------------|-----------------------------|-----------------------|--------------|
|  | September 30, 2008              |                       |              | September 30, 2007          |                       |              |
| <i>(Dollars in thousands)</i>  | Average Outstanding Balance     | Interest Earned/ Paid | Yield/ Rate  | Average Outstanding Balance | Interest Earned/ Paid | Yield/ Rate  |
| <b>Interest-earning assets:</b>  |                                 |                       |              |                             |                       |              |
| Securities available for sale  | \$ 145,713                      | 5,438                 | 4.99%        | \$ 190,231                  | 7,305                 | 5.13%        |
| Loans held for sale  | 2,600                           | 117                   | 6.01         | 2,368                       | 110                   | 6.23         |
| Mortgage loans, net  | 164,661                         | 7,703                 | 6.23         | 142,034                     | 6,531                 | 6.15         |
| Commercial loans, net  | 635,397                         | 32,325                | 6.80         | 593,080                     | 37,530                | 8.46         |
| Consumer loans, net  | 84,181                          | 4,428                 | 7.03         | 84,248                      | 5,461                 | 8.67         |
| Cash equivalents   | 17,645                          | 196                   | 1.48         | 25,516                      | 972                   | 5.09         |
| Federal Home Loan Bank stock   | 6,927                           | 211                   | 4.07         | 6,940                       | 276                   | 5.32         |
| <b>Total interest-earning assets</b>                                       | <b>1,057,124</b>                | <b>50,418</b>         | <b>6.37</b>  | <b>1,044,417</b>            | <b>58,185</b>         | <b>7.45</b>  |
| <b>Interest-bearing liabilities:</b>                                       |                                 |                       |              |                             |                       |              |
| NOW accounts   | 124,869                         | 1,367                 | 1.46         | 113,733                     | 2,685                 | 3.16         |
| Savings accounts   | 41,642                          | 345                   | 1.11         | 40,654                      | 414                   | 1.36         |
| Money market accounts  | 127,299                         | 2,323                 | 2.43         | 222,056                     | 6,314                 | 3.80         |
| Certificates   | 244,313                         | 7,373                 | 4.03         | 235,787                     | 7,815                 | 4.43         |
| Brokered deposits  | 277,288                         | 9,536                 | 4.59         | 193,332                     | 7,278                 | 5.03         |
| Federal Home Loan Bank advances  | 116,209                         | 4,047                 | 4.65         | 122,817                     | 4,227                 | 4.60         |
| <b>Total interest-bearing liabilities</b>                                  | <b>931,620</b>                  | <b>24,991</b>         | <b>3.58</b>  | <b>928,379</b>              | <b>28,733</b>         | <b>4.14</b>  |
| Noninterest checking   | 54,731                          |                       |              | 55,607                      |                       |              |
| Other noninterest bearing escrow deposits                                  | 1,107                           |                       |              | 1,030                       |                       |              |
| <b>Total interest-bearing liabilities and Noninterest bearing deposits</b> | <b>\$ 987,458</b>               |                       |              | <b>\$ 985,016</b>           |                       |              |
| <b>Net interest income</b>   |                                 | <b>\$ 25,427</b>      |              |                             | <b>\$ 29,452</b>      |              |
| <b>Net interest rate spread</b>  |                                 |                       | <b>2.79%</b> |                             |                       | <b>3.31%</b> |
| <b>Net interest margin</b>   |                                 |                       | <b>3.21%</b> |                             |                       | <b>3.77%</b> |

**Provision for Loan Losses**

The provision for loan losses is recorded to bring the allowance for loan losses to a level deemed appropriate by management based on factors disclosed in the critical accounting policies previously discussed. The provision for loan

losses was \$15.8 million for the third quarter of 2008, an increase of \$14.9 million, from \$921,000 for the third quarter of 2007. As discussed previously, the third quarter provision increased \$12.0 million as a result of the full charge off of a loan that was deemed a loss due to the apparent fraudulent activity related to the underlying collateral. The provision for loan losses also increased \$3.4 million due to specific reserves established on two residential development loans as a result of obtaining new third party appraisals of the properties during the quarter. The total amount outstanding on these two loans was \$15.0 million at September 30, 2008.

The provision for loan losses was \$18.5 million for the first nine-months of 2008, an increase of \$16.1 million, from \$2.4 million for the same nine-month period in 2007. The provision increased \$12.0 million as the result of a loan that was charged off in the third quarter of 2008 due to the apparent fraudulent activity related to the underlying collateral. The provision for loan losses also increased \$3.6 million due to specific reserves established on three residential development loans as a result of obtaining new appraisals.

**Table of Contents**

A reconciliation of the Company's allowance for loan losses for the nine-month periods ended September 30, 2008 and 2007 follows:

| <i>(in thousands)</i>        | 2008      | 2007      |
|------------------------------|-----------|-----------|
| Balance at January 1,        | \$ 12,438 | \$ 9,873  |
| Provision                    | 18,480    | 2,404     |
| Charge offs:                 |           |           |
| Commercial loans             | (12,034)  | (16)      |
| Commercial real estate loans | (2,727)   | (138)     |
| Consumer loans               | (633)     | (694)     |
| Recoveries                   | 47        | 123       |
| Balance at September 30,     | \$ 15,571 | \$ 11,552 |

**Non-Interest Income**

Non-interest income was \$2.0 million for the third quarter of 2008, an increase of \$304,000, or 18.4%, from \$1.6 million for the same period in 2007. Securities gains increased \$479,000 as a result of increased investment sales. Fees and service charges increased \$249,000 between the periods primarily because of increased overdraft and debit card fees. Gains on sales of loans decreased \$147,000 due to a decrease in the single-family mortgage and government guaranteed commercial loans that were sold. Mortgage servicing fees decreased \$14,000 due primarily to a decrease in the single-family mortgage loans being serviced. Other non-interest income decreased \$263,000 primarily because of increased losses on the sale of real estate owned in the third quarter of 2008 when compared to the same period in 2007.

Non-interest income was \$5.2 million for the first nine months of 2008, an increase of \$219,000, or 4.4%, from \$5.0 million for the same period in 2007. Fees and service charges increased \$562,000 between the periods primarily because of an increase in overdraft fees and late charges. Security gains increased \$479,000 due to increased investment sales. Gains on sales of loans decreased \$747,000 between the periods primarily because of a \$760,000 decrease in the gains recognized on the sale of government guaranteed commercial loans between the periods. Mortgage servicing fees decreased \$67,000 between the periods due to a decrease in the single-family mortgage loans being serviced.

**Non-Interest Expense**

Non-interest expense was \$6.6 million for the third quarter of 2008, an increase of \$608,000, or 10.2%, from \$6.0 million for the same period of 2007. Other noninterest expenses increased \$722,000 primarily because of a litigation settlement on a loan participation and increased legal fees primarily related to an ongoing state tax assessment challenge. Data processing costs increased \$74,000 primarily because of increased fees related to the data processing system conversion that will occur in the fourth quarter of 2008. Compensation expense decreased \$137,000 between the periods primarily because of decreased employee incentive accruals and pension costs. Advertising expense decreased \$28,000 between the periods due to decreased promotional advertising. Amortization of mortgage servicing rights decreased \$27,000 due to a decrease in the single-family mortgage loans being serviced.

Non-interest expense was \$22.6 million for the first nine months of 2008, an increase of \$4.5 million, or 25.3%, from \$18.1 million for the same period in 2007. A goodwill impairment charge of \$3.8 million was recorded in the second quarter of 2008 as goodwill related to a 1997 acquisition was deemed to be impaired and fully written off due to the trading of the Company's common stock at a discount to book value. Other non-interest expense increased \$1.1 million between the periods primarily because of increased Federal Deposit Insurance Corporation (FDIC) insurance costs, a litigation settlement related to a loan participation and increased legal fees primarily related to an ongoing state tax assessment challenge. Data processing costs increased \$136,000 primarily because of increased fees related to the data processing system conversion that will occur in the fourth quarter of 2008. Occupancy expense increased \$101,000 due primarily to increased real estate taxes and costs associated with the Eagan location that was opened in the third quarter of 2007 and the additional Rochester location that was opened in the third quarter of 2008. Compensation



expense decreased \$364,000 between the periods primarily because of

20

---

**Table of Contents**

decreased employee incentive accruals and pension costs. Advertising expense decreased \$113,000 between the periods due to a decrease in promotional event sponsorships. Amortization of mortgage servicing rights decreased \$84,000 due to a decrease in single-family mortgage loans being serviced.

**Income Tax (Benefit) Expense**

The income tax benefit realized was \$4.8 million for the third quarter of 2008, a decrease of \$6.6 million from the \$1.8 million in income tax expense in the third quarter of 2007. The effective income tax rate for the third quarter of 2007 was 39.4% compared to a benefit of 40.4% for the third quarter of 2008.

The income tax benefit was \$2.9 million for the first nine months of 2008, a decrease of \$8.4 million compared to \$5.5 million in income tax expense for the first nine months of 2007. The effective income tax rate for the first nine months of 2007 was 39.3% compared to a benefit of 27.3% for the first nine months of 2008. The difference in the effective rates between the periods is primarily related to the \$3.8 million goodwill impairment charge recorded in the second quarter of 2008 as it is not tax deductible and therefore no tax benefit was recorded.

**Non-Performing Assets**

The following table summarizes the amounts and categories of non-performing assets in the Bank's portfolio and loan delinquency information as of the end of the two most recently completed quarters and December 31, 2007.

| <i>(Dollars in thousands)</i>                        | September<br>30,<br>2008 | June 30,<br>2008 | December<br>31,<br>2007 |
|--|--------------------------|------------------|-------------------------|
| Non-Accruing Loans:                                  |                          |                  |                         |
| One-to-four family real estate                       | \$ 620                   | \$ 1,046         | \$ 1,196                |
| Commercial real estate                               | 32,554                   | 39,221           | 15,641                  |
| Consumer   | 997                      | 1,439            | 1,094                   |
| Commercial business                                  | 2,253                    | 2,500            | 1,723                   |
| Total  | 36,424                   | 44,206           | 19,654                  |
| Other assets   | 25                       | 25               | 34                      |
| Foreclosed and Repossessed Assets:                   |                          |                  |                         |
| One-to-four family real estate                       | 552                      | 2,731            | 901                     |
| Consumer   | 0                        | 19               | 33                      |
| Commercial real estate                               | 8,247                    | 1,541            | 1,313                   |
| Total non-performing assets                          | \$ 45,248                | \$ 48,522        | \$ 21,935               |
| Total as a percentage of total assets                | 4.01%                    | 4.49%            | 1.96%                   |
| Total non-performing loans                           | \$ 36,424                | \$ 44,206        | \$ 19,654               |
| Total as a percentage of total loans receivable, net | 4.17%                    | 4.94%            | 2.27%                   |
| Allowance for loan loss to non-performing loans      | 42.75%                   | 33.76%           | 63.28%                  |
| Delinquency Data:                                    |                          |                  |                         |
| Delinquencies <sup>(1)</sup>                         |                          |                  |                         |
| 30+ days   | \$ 4,354                 | \$ 2,491         | \$ 6,416                |

Edgar Filing: HMN FINANCIAL INC - Form 10-Q

|  |       |       |       |
|--|-------|-------|-------|
| 90+ days   | 0     | 0     | 0     |
| Delinquencies as a percentage of loan and lease portfolio <sup>(1)</sup> |       |       |       |
| 30+ days   | 0.49% | 0.27% | 0.73% |
| 90+ days   | 0.00% | 0.00% | 0.00% |

(1) Excludes  
non-accrual  
loans.

Non-performing assets were \$45.2 million at September 30, 2008, a decrease of \$3.3 million, or 6.7%, from \$48.5 million at June 30, 2008. Non-performing loans decreased \$7.8 million and foreclosed and repossessed assets increased \$4.5 million during the period. The non-performing loan activity for the quarter was as follows: classified \$14.5 million in loans as non-accruing, received \$656,000 in principal payments on non-accruing loans, reclassified \$363,000 in loans as accruing, transferred \$6.7 million to real estate owned and charged off \$14.5 million of loans. The allowances for nonperforming loans are reviewed for adequacy based on an estimate of the market values of the underlying collateral less estimated selling costs. Action plans for non-performing loans are evaluated and implemented in order to minimize the Company's losses and reduce the amount of non-performing assets as quickly as possible. Foreclosed and repossessed assets increased \$4.5 million during the third quarter of

**Table of Contents**

2008 primarily due to the foreclosure of a non-performing single family development loan during the quarter. The non-performing foreclosed and repossessed asset activity for the quarter was as follows: transferred \$8.8 million to real estate owned, sold \$2.3 million of real estate owned and charged off \$2.0 million. In addition to the non-performing assets set forth in the table above, there was one residential development loan for \$5.9 million, for which the interest rate was modified in a troubled debt restructuring in the third quarter of 2008. This loan was not classified as non-performing as it is anticipated that the borrower will be able to make all of the required principal and interest payments under the modified terms of the loan.

Non-performing assets were \$45.2 million at September 30, 2008, an increase of \$23.3 million, or 106.3%, from \$21.9 million at December 31, 2007. Non-performing loans increased \$16.8 million and foreclosed and repossessed assets increased \$6.5 million during the period. The non-performing loan activity for the first nine months of 2008 was as follows: classified \$44.9 million in loans as non-accruing, received \$2.1 million in principal payments on non-accruing loans, reclassified \$3.1 million in loans as accruing, transferred \$8.0 million to real estate owned and charged off \$14.9 million of loans. The allowances for nonperforming loans are reviewed for adequacy at least quarterly based on an estimate of the market values of the underlying collateral. However, no assurance can be given that HMN will not, in any particular period, sustain loan losses that are sizable in relation to the amount reserved, or that subsequent evaluations of the loan portfolio, HMN's ongoing credit review process or regulatory requirements, will not require significant changes in the allowance for loan losses. Among other factors, a protracted economic slowdown, a continued decline in commercial or residential real estate values in HMN's markets and continued financial stress on consumers would have an adverse impact on the current adequacy of the allowance for loan losses by increasing credit risk and the risk of potential loss.

**Dividends**

On October 20, 2008, the Company announced that the quarterly dividend would be suspended. The Company had declared and paid dividends during 2008 as follows:

| Record date       | Pay date          | Dividend per share | Dividend Payout Ratio |
|-------------------|-------------------|--------------------|-----------------------|
| February 15, 2008 | March 7, 2008     | \$ 0.25            | 34.25%                |
| May 16, 2008      | June 6, 2008      | \$ 0.25            | 64.10%                |
| August 25, 2008   | September 8, 2008 | \$ 0.25            | (44.64)%              |

The annualized dividend payout ratio for the past four quarters, ending with the September 8, 2008 payment was 78.74%.

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 including risk based capital requirements, tax considerations, industry standards, economic conditions, regulatory restrictions, general business practices and other factors. The Board's decision to suspend the dividend is a result of a very challenging economic environment that is affecting the entire financial sector. The Company believes that this is the best course for the shareholders over the long term. The Bank's capital position at September 30, 2008 remained above the levels required for the Bank to be considered a well-capitalized financial institution by regulatory standards. The severity of the financial and credit crisis in the broad market and the unknown duration of the economic slowdown deem it imperative to protect, preserve and maximize our capital for the future. The Board and management are committed to successfully managing credit risk and to maintain adequate levels of capital and liquidity in the current challenging economic environment.

**Liquidity and Capital Resources**

For the nine months ended September 30, 2008, the net cash provided by operating activities was \$12.9 million. The Company collected \$85.0 million from the maturities of securities, \$2.8 million from principal repayments on securities, \$10.4 million from the sale of investments and \$233,000 of customer escrows. It purchased securities available for sale of \$99.4 million and premises and equipment of \$2.7 million. Net loans receivable increased \$40.6 million due to an increase in commercial loan originations. The Company had a net increase in deposit balances of \$518,000, received \$347.7 million and repaid \$318.7 million in FHLB/FRB advances, and purchased \$6.0 million of FHLB stock and received \$4.7 million from the redemption of FHLB stock. The Company



**Table of Contents**

purchased \$723,000 of its own stock and paid \$2.7 million in dividends to its shareholders.

The Company has certificates of deposits with outstanding balances of \$286.1 million that come due over the next 12 months. Based upon past experience, management anticipates that the majority of the deposits will renew for another term. The Company believes that deposits that do not renew will be replaced with deposits from other customers or brokers. FHLB/FRB advances or proceeds from the sale of securities could also be used to replace unanticipated outflows of deposits. The Company has established combined lines of credit with the FHLB/FRB and unpledged investment securities totaling \$302.4 million at September 30, 2008 that could be used to fund any short-term cash needs.

The Company has deposits of \$31.5 million in checking and money market accounts with customers that have individual balances greater than \$5.0 million. These funds may be withdrawn at any time, and management anticipates that the majority of these deposits will not be withdrawn from the Bank over the next twelve months. If these deposits are withdrawn, they would be funded with the proceeds from maturing investments or replaced with FHLB/FRB advances or deposits from other customers or brokers.

The Company has \$87.5 million of FHLB advances which mature beyond September 30, 2009 but have call features that can be exercised by the FHLB during the next twelve months. As the advances mature or if the call features are exercised, the Company has the option of requesting any advance otherwise available to it pursuant to the Credit Policy of the FHLB.

The Bank remains well capitalized under applicable regulatory standards as of September 30, 2008. Nevertheless, the Company and the Bank may pursue sources of additional capital from time to time if such capital can be obtained on favorable terms. Currently, the Company is evaluating the Capital Purchase Program recently announced by the United States Treasury Department as a source of additional capital. Any future capital raising transaction by the Company could dilute the ownership of current holders of the Company's common stock, reduce the Company's future fully diluted earnings per share, or depress the trading price of the Company's common stock. In addition, the terms of the transactions under which capital is raised could limit the Company's ability to pay dividends on, or make repurchase of, its common stock.

***Market Risk***

Market risk is the risk of loss from adverse changes in market prices and interest 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 which 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 Company believes that over the next twelve months interest rates could fluctuate in a range of 100 basis points down or 200 basis points up from where the interest rates were at September 30, 2008. 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, 2008.

**Table of Contents**

## Other than trading portfolio

*(Dollars in thousands)*

|   | Market Value |           |           |           |
|---|--------------|-----------|-----------|-----------|
| Basis point change in interest rates        | -100         | 0         | +100      | +200      |
| Total market risk sensitive assets          | \$ 1,128,885 | 1,109,775 | 1,088,878 | 1,066,980 |
| Total market risk sensitive liabilities     | 1,037,408    | 1,024,120 | 1,010,896 | 998,999   |
| Off-balance sheet financial instruments     | (85)         | 0         | 164       | 310       |
| Net market risk                             | \$ 91,562    | 85,655    | 77,818    | 67,671    |
| Percentage change from current market value | 6.90%        | 0.00%     | (9.15)%   | (21.00)%  |

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 7% to 76%, depending on the note rate and the period to maturity. Adjustable rate mortgages (ARMs) were assumed to prepay at annual rates of between 11% and 32%, depending on the note rate and the period to maturity. Growing Equity Mortgage (GEM) loans were assumed to prepay at annual rates of between 6% and 49% 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 24%, money market accounts were assumed to decay at an annual rate of 31%, non-interest checking and NOW accounts were assumed to decay at annual rates of 33% and 28%, respectively. Commercial NOW accounts and MMDA accounts were assumed to decay at annual rates of 24% and 31%, respectively. 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 Company's callable advance.

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 (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 or floors 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 or economic slow down.

**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, 2008 to determine if its current level of interest rate risk is acceptable. The following table projects the estimated annual impact on net interest income of immediate interest rate changes called rate shocks.

|                               | Rate Shock | Projected Change |            |
|-------------------------------|------------|------------------|------------|
|                               | in Basis   | in               | Percentage |
|                               | Points     | Net Interest     | Change     |
|                               | +200       | Income           |            |
| <i>(Dollars in thousands)</i> |            | \$ 1,899         | 6.16 %     |

Edgar Filing: HMN FINANCIAL INC - Form 10-Q

|    |      |       |        |
|----|------|-------|--------|
|    | +100 | 461   | 1.50   |
|    | 0    | 0     | 0.00   |
|    | -100 | (821) | (2.66) |
| 24 |      |       |        |

---



**Table of Contents**

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 net interest income in a rising rate environment is because at September 30, 2008 we had more loans than deposits 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. 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 places only those fixed rate loans that meet certain risk characteristics into its loan portfolio. The Bank does place into portfolio adjustable rate single-family loans that reprice over a one, three or five-year period. The Bank's commercial loan production has primarily been in adjustable rate loans while the fixed rate commercial loans placed in portfolio have been shorter-term loans, usually with maturities of five years or less, in order to manage the Company's interest rate risk exposure.

**Off-Balance Sheet Arrangements**

The Company has no off-balance sheet arrangements other than commitments to originate 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 control 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 control over financial reporting.

**Table of Contents**

**HMN FINANCIAL, INC.**  
**PART II OTHER INFORMATION**

**ITEM 1. Legal Proceedings.**

From time to time, HMN is party to legal proceedings arising out of its lending and deposit operations. HMN 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.

**ITEM 1A. Risk Factors.**

The United States, including HMN's markets, has experienced weakening economic conditions and declines in housing prices and real estate values in general. As discussed in Part I, Item 1A, Risk Factors, and Part II, Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations in HMN's Annual Report on Form 10-K dated December 31, 2007 and in Part I, Item 2 of this Form 10-Q for the quarterly period ended September 30, 2008, HMN's loan portfolio contain significant amounts of loans secured by residential and commercial real estate. HMN has experienced increases in non-performing assets, net charge-offs and provisions for credit losses as a result of continuing deterioration of the housing markets, increasing financial stress on consumers and weakening economic conditions. In the event of worsening economic conditions and continued decline in real estate values, HMN would expect continued deterioration of credit quality represented by increased balances of non-performing assets, increased net charge-offs and increased provisions for credit losses.

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

(a) and (b) Not applicable

(c) Information Regarding Share Repurchases

| Period                                 | (a)<br>Total<br>Number<br>of<br>Shares<br>Purchased | (b) Average<br>Price<br>Paid per<br>Share | (c) Total<br>Number of<br>Shares<br>Purchased as<br>Part<br>of Publicly<br>Announced<br>Plans or<br>Programs | (d) Maximum<br>Number<br>of Shares that May<br>Yet<br>Be Purchased Under<br>the Plans<br>or Programs (1) |
|--|---|---|--|--|
| July 1 through July 31, 2008           | 0   | \$ N/A                                    | 0  | 300,000  |
| August 1 through August 31, 2008       | 0   | N/A                                       | 0  | 300,000  |
| September 1 through September 30, 2008 | 0   | N.A                                       | 0  | 300,000  |
| Total                                  | 0   | \$ N/A                                    | 0  |  |

(1) On July 22, 2008 the Board of Directors authorized the repurchase of up to 300,000 shares of the Company's common stock. This program expires on

January 26,  
2010.

**ITEM 3. Defaults Upon Senior Securities.**

Not applicable.

**ITEM 4. Submission of Matters to a Vote of Security Holders.**

None.

**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.

**Table of Contents**

**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 3, 2008

/s/ Michael McNeil  
Michael McNeil,  
President/Chief Executive Officer  
(Principal Executive Officer)  
(Duly Authorized Representative)

Date: November 3, 2008

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

**Table of Contents**

**HMN FINANCIAL, INC.  
INDEX TO EXHIBITS  
FOR FORM 10-Q**

| Regulation<br>S-K<br>Exhibit<br>Number | Document Attached Hereto                       | Reference<br>to Prior<br>Filing or<br>Exhibit<br>Number | Sequential<br>Page Numbering<br>Where Attached<br>Exhibits Are<br>Located in This<br>Form 10-Q Report |
|--|--|---|---|
| 3.1                                    | Amended and Restated Articles of Incorporation | *1  | N/A   |
| 3.2                                    | Amended and Restated By-laws                   | *2  | N/A   |
| 4                                      | Form of Common Stock Including indentures      | *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  |

\*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 to the Company's Current Report on Form 8-K dated August 26, 2008 (File No. 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).