

HMN FINANCIAL INC
Form 10-Q
May 05, 2011

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**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 March 31, 2011
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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

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

Large accelerated filer Accelerated filer Non-accelerated filer 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 classes of common stock as of the latest practicable date.

Class Outstanding at April 20, 2011

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Common stock, \$0.01 par value

4,388,399

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Table of Contents**PART I FINANCIAL INFORMATION****Item 1 : Financial Statements****HMN FINANCIAL, INC. AND SUBSIDIARIES
Consolidated Balance Sheets**

| <i>(Dollars in thousands)</i> | March 31, 2011 (unaudited) | December 31, 2010 |
|--|----------------------------------|-------------------------|
| Assets | | |
| Cash and cash equivalents | \$ 39,976 | 20,981 |
| Securities available for sale: | | |
| Mortgage-backed and related securities (amortized cost \$28,284 and \$32,036) | 29,641 | 33,506 |
| Other marketable securities (amortized cost \$128,652 and \$118,631) | 128,002 | 118,058 |
| | 157,643 | 151,564 |
| Loans held for sale | 1,624 | 2,728 |
| Loans receivable, net | 634,282 | 664,241 |
| Accrued interest receivable | 3,221 | 3,311 |
| Real estate, net | 21,469 | 16,382 |
| Federal Home Loan Bank stock, at cost | 6,410 | 6,743 |
| Mortgage servicing rights, net | 1,575 | 1,586 |
| Premises and equipment, net | 9,123 | 9,450 |
| Prepaid expenses and other assets | 3,433 | 3,632 |
| Deferred tax asset, net | 0 | 0 |
| Total assets | \$ 878,756 | 880,618 |
| Liabilities and Stockholders Equity | | |
| Deposits | \$ 688,078 | 683,230 |
| Federal Home Loan Bank advances and Federal Reserve borrowings | 115,000 | 122,500 |
| Accrued interest payable | 917 | 1,092 |
| Customer escrows | 1,422 | 818 |
| Accrued expenses and other liabilities | 3,698 | 3,431 |
| Total liabilities | 809,115 | 811,071 |
| Commitments and contingencies | | |
| Stockholders equity: | | |
| Serial preferred stock (\$.01 par value): | | |
| Authorized 500,000 shares; issued shares 26,000 | 24,390 | 24,264 |
| Common stock (\$.01 par value): | | |
| Authorized 11,000,000; issued shares 9,128,662 | 91 | 91 |
| Additional paid-in capital | 53,662 | 56,420 |

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| | | |
|--|------------|----------|
| Retained earnings, subject to certain restrictions | 55,930 | 55,838 |
| Accumulated other comprehensive income, net of tax | 427 | 541 |
| Unearned employee stock ownership plan shares | (3,336) | (3,384) |
| Treasury stock, at cost 4,740,263 and 4,818,263 shares | (61,523) | (64,223) |
| Total stockholders' equity | 69,641 | 69,547 |
| Total liabilities and stockholders' equity | \$ 878,756 | 880,618 |

See accompanying notes to consolidated financial statements.

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

| <i>(Dollars in thousands)</i> | Three Months Ended March 31, | |
|--|---------------------------------|------------|
| | 2011 | 2010 |
| Interest income: | | |
| Loans receivable | \$ 9,903 | 11,759 |
| Securities available for sale: | | |
| Mortgage-backed and related | 324 | 535 |
| Other marketable | 417 | 572 |
| Cash equivalents | 1 | 1 |
| Other | 69 | 37 |
| Total interest income | 10,714 | 12,904 |
| Interest expense: | | |
| Deposits | 1,940 | 3,421 |
| Federal Home Loan Bank advances and Federal Reserve borrowings | 1,329 | 1,522 |
| Total interest expense | 3,269 | 4,943 |
| Net interest income | 7,445 | 7,961 |
| Provision for loan losses | 1,946 | 6,533 |
| Net interest income after provision for loan losses | 5,499 | 1,428 |
| Non-interest income: | | |
| Fees and service charges | 924 | 842 |
| Loan servicing fees | 250 | 268 |
| Gain on sales of loans | 495 | 314 |
| Other | 117 | 150 |
| Total non-interest income | 1,786 | 1,574 |
| Non-interest expense: | | |
| Compensation and benefits | 3,560 | 3,449 |
| Loss (gain) on real estate owned | 47 | (761) |
| Occupancy | 940 | 1,031 |
| Deposit insurance | 404 | 517 |
| Data processing | 253 | 276 |
| Other | 1,588 | 1,505 |
| Total non-interest expense | 6,792 | 6,017 |

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| | | |
|---|-----------|---------|
| Income (loss) before income tax expense (benefit) | 493 | (3,015) |
| Income tax expense (benefit) | 76 | (1,168) |
| Net income (loss) | 417 | (1,847) |
| Preferred stock dividends and discount | (449) | (440) |
| Net loss available to common shareholders | (32) | (2,287) |
| Basic loss per common share | \$ (0.01) | (0.61) |
| Diluted loss per common share | \$ (0.01) | (0.61) |

See accompanying notes to consolidated financial statements.

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HMN FINANCIAL, INC. AND SUBSIDIARIES
Consolidated Statement of Stockholders' Equity and Comprehensive Income
For the Three Month Period Ended March 31, 2011
(unaudited)

| <i>(Dollars in thousands)</i> | Preferred Stock | Common Stock | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Income | Unearned Employee Stock Ownership Plan Shares | Treasury Stock | Total Stock- Holders Equity |
|--|--------------------|-----------------|----------------------------------|----------------------|---|--|-------------------|--------------------------------------|
| Balance, December 31, 2010 | \$24,264 | 91 | 56,420 | 55,838 | 541 | (3,384) | (64,223) | 69,547 |
| Net income | | | | 417 | | | | 417 |
| Other comprehensive loss, net of tax: | | | | | | | | |
| Net unrealized losses on securities available for sale | | | | | (114) | | | (114) |
| Total comprehensive income | | | | | | | | 303 |
| Preferred stock discount amortization | 126 | | (126) | | | | | 0 |
| Stock compensation tax benefits | | | 8 | | | | | 8 |
| Unearned compensation restricted stock awards | | | (2,700) | | | | 2,700 | 0 |
| Amortization of restricted stock awards | | | 79 | | | | | 79 |
| Preferred stock dividends accrued | | | | (325) | | | | (325) |
| Earned employee stock ownership plan shares | | | (19) | | | 48 | | 29 |
| Balance, March 31, 2011 | \$24,390 | 91 | 53,662 | 55,930 | 427 | (3,336) | (61,523) | 69,641 |

See accompanying notes to consolidated financial statements.

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

| <i>(Dollars in thousands)</i> | Three Months Ended March 31, | |
|--|---------------------------------|----------|
| | 2011 | 2010 |
| Cash flows from operating activities: | | |
| Net income (loss) | \$ 417 | (1,847) |
| Adjustments to reconcile net income (loss) to cash provided by operating activities: | | |
| Provision for loan losses | 1,946 | 6,533 |
| Depreciation | 327 | 397 |
| Amortization of premiums, net | 69 | 186 |
| Amortization of deferred loan fees | (236) | (73) |
| Amortization of mortgage servicing rights, net | 98 | 109 |
| Capitalized mortgage servicing rights | (87) | (150) |
| Deferred income tax expense (benefit) | 76 | (1,792) |
| Loss (gain) on sales of real estate | 47 | (761) |
| Gain on sales of loans | (495) | (314) |
| Proceeds from sale of loans held for sale | 14,266 | 16,361 |
| Disbursements on loans held for sale | (9,812) | (14,348) |
| Amortization of restricted stock awards | 79 | 97 |
| Amortization of unearned ESOP shares | 48 | 48 |
| Earned employee stock ownership shares priced below original cost | (19) | (10) |
| Stock option compensation | 8 | 16 |
| Decrease in accrued interest receivable | 90 | 238 |
| Decrease in accrued interest payable | (175) | (361) |
| Decrease in other assets | 153 | 440 |
| Increase (decrease) in other liabilities | (61) | 368 |
| Other, net | 41 | 1 |
| Net cash provided by operating activities | 6,780 | 5,138 |
| Cash flows from investing activities: | | |
| Principal collected on securities available for sale | 3,756 | 5,168 |
| Proceeds collected on maturities of securities available for sale | 30,000 | 17,000 |
| Purchases of securities available for sale | (40,032) | (25,072) |
| Redemption of Federal Home Loan Bank stock | 333 | 0 |
| Proceeds from sales of real estate | 1,055 | 5,431 |
| Net decrease in loans receivable | 19,212 | 16,251 |
| Purchases of premises and equipment | 0 | (34) |
| Net cash provided by investing activities | 14,324 | 18,744 |
| Cash flows from financing activities: | | |
| Increase (decrease) in deposits | 4,787 | (6,359) |
| Dividends paid to preferred stockholders | 0 | (325) |
| Proceeds from borrowings | 0 | 5,000 |

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| | | |
|--|-----------|---------|
| Repayment of borrowings | (7,500) | (5,000) |
| Increase in customer escrows | 604 | 685 |
| Net cash used by financing activities | (2,109) | (5,999) |
| Increase in cash and cash equivalents | 18,995 | 17,883 |
| Cash and cash equivalents, beginning of period | 20,981 | 16,418 |
| Cash and cash equivalents, end of period | \$ 39,976 | 34,301 |
| Supplemental cash flow disclosures: | | |
| Cash paid for interest | \$ 3,443 | 5,304 |
| Cash paid for income taxes | 0 | 39 |
| Supplemental noncash flow disclosures: | | |
| Transfer of loans to real estate | 6,231 | 1,138 |
| Loans transferred to loans held for sale | 2,806 | 1,072 |
| See accompanying notes to consolidated financial statements. | | |

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HMN FINANCIAL, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
(unaudited)
March 31, 2011 and 2010

(1) *HMN Financial, Inc.*

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

(2) *Basis of Preparation*

The accompanying unaudited consolidated financial statements were prepared in accordance with instructions for Form 10-Q and therefore, do not include all disclosures necessary for a complete presentation of the consolidated balance sheets, consolidated statements of income (loss), 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 results of operations for the three-month period ended March 31, 2011 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 July 2010, the FASB issued ASU 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*, which requires significant new disclosures about the allowance for credit losses and the credit quality of financing receivables. The requirements are intended to enhance transparency regarding credit losses and the credit quality of loan and lease receivables. Under this statement, allowance for credit losses and fair value are to be disclosed by portfolio segment, while credit quality information, impaired financing receivables and nonaccrual status are to be presented by class of financing receivable. Disclosure of the nature and extent, the financial impact and segment information of troubled debt restructurings are also required. The disclosures are to be presented at the level of disaggregation that management uses when assessing and monitoring the portfolio's risk and performance. This ASU is effective for interim and annual reporting periods after December 15, 2010 and the related disclosures were included in Note 5 in the Company's December 31, 2010 notes to the consolidated financial statements and in Note 9 of this quarterly report.

In January 2011, the FASB issued ASU 2011-01, *Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20*. The amendment temporarily delays the effective date of the disclosures about troubled debt restructurings in ASU No. 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses* for public entities.

In April 2011, the FASB issued ASU 2011-02, *Receivables (Topic 310), A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring*. This ASU provides guidance on evaluating whether a restructuring constitutes a troubled debt restructuring. It indicates that if a creditor separately concludes that a restructuring constitutes a concession and that the debtor is experiencing financial difficulties that the restructuring is a troubled debt restructuring. It also clarifies guidance on a creditor's evaluation of the above two items. For public entities, such as HMN, the amendments in this ASU are effective for the first interim or annual

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period beginning on or after June 15, 2011, and should be applied retrospectively to the beginning of the annual period of adoption. In addition, this ASU requires that the disclosures about troubled debt restructurings that were delayed by ASU 2011-01 in January 2011 be disclosed for interim and annual periods beginning on or after June 15, 2011. It is anticipated the implementation of the guidance in this ASU will result in more loan restructurings being classified as troubled debt restructurings.

(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 March 31, 2011, the Company recorded an increase in other assets of \$4,000, an increase in other liabilities of \$3,000 and a gain included in the gain on sales of loans of \$1,000.

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 other assets of \$50,000 and a decrease in the mark to market adjustment for loans held for sale of \$50,000.

(5) Fair Value Measurements

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

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

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

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

The following table summarizes the assets of the Company for which fair values are determined on a recurring basis as of March 31, 2011 and December 31, 2010.

| <i>(Dollars in thousands)</i> | Carrying value at March 31, 2011 | | | |
|-------------------------------|----------------------------------|---------|---------|---------|
| | Total | Level 1 | Level 2 | Level 3 |
| Securities available for sale | \$ 157,643 | 1,313 | 156,330 | 0 |
| Mortgage loan commitments | (4) | 0 | (4) | 0 |
| Total | \$ 157,639 | 1,313 | 156,326 | 0 |

| <i>(Dollars in thousands)</i> | Carrying value at December 31, 2010 | | | |
|-------------------------------|-------------------------------------|---------|---------|---------|
| | Total | Level 1 | Level 2 | Level 3 |
| Securities available for sale | \$ 151,564 | 1,740 | 149,824 | 0 |
| Mortgage loan commitments | (1) | 0 | (1) | 0 |

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| | | | | |
|-------|------------|-------|---------|---|
| Total | \$ 151,563 | 1,740 | 149,823 | 0 |
|-------|------------|-------|---------|---|

There were no transfers between Levels 1, 2, or 3 during the three months ended March 31, 2011.

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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 that were still held at March 31, 2011 and December 31, 2010, 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 March 31, 2011 and December 31, 2010.

| <i>(Dollars in thousands)</i> | Carrying value at March 31, 2011 | | | | Three months ended March 31, 2011 |
|---------------------------------|----------------------------------|----------|---------------|----------|--------------------------------------|
| | Total | Level | | Level | Total Losses |
| | | 1 | Level 2 | 3 | |
| Loans held for sale | \$ 1,624 | 0 | 1,624 | 0 | (7) |
| Mortgage servicing rights | 1,575 | 0 | 1,575 | 0 | 0 |
| Loans ⁽¹⁾ | 61,272 | 0 | 61,272 | 0 | (2,082) |
| Real estate, net ⁽²⁾ | 21,469 | 0 | 21,469 | 0 | (88) |
| Total | \$ 85,940 | 0 | 85,940 | 0 | (2,177) |

| <i>(Dollars in thousands)</i> | Carrying value at December 31, 2010 | | | | Year ended December 31, 2010 |
|---------------------------------|-------------------------------------|----------|---------------|----------|------------------------------------|
| | Total | Level | | Level | Total Losses |
| | | 1 | Level 2 | 3 | |
| Loans held for sale | \$ 2,728 | 0 | 2,728 | 0 | (6) |
| Mortgage servicing rights | 1,586 | 0 | 1,586 | 0 | 0 |
| Loans ⁽¹⁾ | 43,039 | 0 | 43,039 | 0 | (18,855) |
| Real estate, net ⁽²⁾ | 16,385 | 0 | 16,385 | 0 | (1,782) |
| Total | \$ 63,738 | 0 | 63,738 | 0 | (20,643) |

(1) Represents carrying value and related write-downs of loans for which adjustments are based on the appraised value of the collateral. The carrying value of loans fully charged-off is zero.

(2) Represents the fair value and related losses of foreclosed real estate and other collateral owned that were measured at fair value subsequent to their initial classification as foreclosed assets.

(6) Fair Value of Financial Instruments

Generally accepted accounting principles require interim reporting period disclosure about the fair value of financial instruments, including assets, liabilities and off-balance sheet items for which it is practicable to estimate fair value. The fair value estimates are made based upon relevant market information, if available, and upon the characteristics of the financial instruments themselves. Because no market exists for a significant portion of the Company's financial instruments, fair value estimates are based upon judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments and other factors. The estimated fair value of the Company's financial instruments as of March 31, 2011 and December 31, 2010 are shown below.

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| <i>(Dollars in thousands)</i> | March 31, 2011 | | | December 31, 2010 | | |
|---|--------------------|-------------------------|--------------------|----------------------|-------------------------|--------------------|
| | Carrying amount | Estimated fair value | Contract amount | Carrying amount | Estimated fair value | Contract amount |
| Financial assets: | | | | | | |
| Cash and cash equivalents | \$ 39,976 | 39,976 | | 20,981 | 20,981 | |
| Securities available for sale | 157,643 | 157,643 | | 151,564 | 151,564 | |
| Loans held for sale | 1,624 | 1,624 | | 2,728 | 2,728 | |
| Loans receivable, net | 634,282 | 625,565 | | 664,241 | 655,508 | |
| Federal Home Loan Bank stock | 6,410 | 6,410 | | 6,743 | 6,743 | |
| Accrued interest receivable | 3,221 | 3,221 | | 3,311 | 3,311 | |
| Financial liabilities: | | | | | | |
| Deposits | 688,078 | 688,078 | | 683,230 | 683,230 | |
| Federal Home Loan Bank advances | 115,000 | 120,976 | | 122,500 | 129,893 | |
| Accrued interest payable | 917 | 917 | | 1,092 | 1,092 | |
| Off-balance sheet financial instruments: | | | | | | |
| Commitments to extend credit | (4) | (4) | 94,594 | 56 | 56 | 92,313 |
| Commitments to sell loans | 11 | 11 | 3,419 | (1) | (1) | 3,413 |

(7) Other Comprehensive Loss

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

| <i>(Dollars in thousands)</i> | For the period ended March 31, | | | | | |
|--|--------------------------------|-----------------------|---------------|---------------|-----------------------|---------------|
| | Before tax | 2011 Tax effect | Net of tax | Before tax | 2010 Tax effect | Net of tax |
| Securities available for sale: | | | | | | |
| Net unrealized losses arising during the period | \$ (190) | (76) | (114) | (376) | (149) | (227) |
| Other comprehensive loss | \$ (190) | (76) | (114) | (376) | (149) | (227) |

(8) 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 March 31, 2011 and December 31, 2010.

| <i>(Dollars in thousands)</i> | Less than twelve months | | | March 31, 2011 Twelve months or more | | | Total | |
|-------------------------------|-------------------------|---------------|----------------------|---|---------------|----------------------|---------------|----------------------|
| | # of Investments | Fair Value | Unrealized Losses | # of Investments | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |

| | | | | | | | | |
|---------------------------------------|----|----------|-------|---|-------|-------|----------|-------|
| Other marketable securities: | | | | | | | | |
| U.S. Government agency obligations | 13 | \$62,681 | (225) | 0 | \$ 0 | 0 | \$62,681 | (225) |
| Corporate preferred stock | 0 | 0 | 0 | 1 | 175 | (525) | 175 | (525) |
| Total temporarily impaired securities | 13 | \$62,681 | (225) | 1 | \$175 | (525) | \$62,856 | (750) |

December 31, 2010

| <i>(Dollars in thousands)</i> | 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 |
| Other marketable securities: | | | | | | | | |
| U.S. Government agency obligations | 10 | \$47,610 | (266) | 0 | \$ 0 | 0 | \$47,610 | (266) |
| Corporate preferred stock | 0 | 0 | 0 | 1 | 175 | (525) | 175 | (525) |
| Total temporarily impaired securities | 10 | \$47,610 | (266) | 1 | \$175 | (525) | \$47,785 | (791) |

We review our investment portfolio on a quarterly basis for indications of impairment. This review includes

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analyzing the length of time and the extent to which the fair value has been lower than the cost, the market liquidity for the investment, the financial condition and near-term prospects of the issuer, including any specific events which may influence the operations of the issuer, and our intent and ability to hold the investment for a period of time sufficient to recover the temporary loss. The unrealized losses on collateralized mortgage and agency obligations are primarily due to changes in interest rates and were not determined to be other-than-temporary. Mortgage backed securities in the table above had an average life of less than three years and the other marketable securities had an average life of less than two years at March 31, 2011.

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

A summary of securities available for sale at March 31, 2011 and December 31, 2010 is as follows:

| <i>(Dollars in thousands)</i> | Amortized cost | Gross unrealized gains | Gross unrealized losses | Fair value |
|--------------------------------------|-------------------|------------------------------|-------------------------------|---------------|
| March 31, 2011: | | | | |
| Mortgage-backed securities: | | | | |
| FHLMC | \$ 15,708 | 705 | 0 | 16,413 |
| FNMA | 11,301 | 614 | 0 | 11,915 |
| Collateralized mortgage obligations: | | | | |
| FHLMC | 894 | 31 | 0 | 925 |
| FNMA | 381 | 7 | 0 | 388 |
| | 28,284 | 1,357 | 0 | 29,641 |
| Other marketable securities: | | | | |
| U.S. Government agency obligations | 127,952 | 100 | (225) | 127,827 |
| Corporate preferred stock | 700 | 0 | (525) | 175 |
| | 128,652 | 100 | (750) | 128,002 |
| | \$ 156,936 | 1,457 | (750) | 157,643 |

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| <i>(Dollars in thousands)</i> | Amortized cost | Gross unrealized gains | Gross unrealized losses | Fair value |
|--------------------------------------|-------------------|------------------------------|-------------------------------|---------------|
| December 31, 2010: | | | | |
| Mortgage-backed securities: | | | | |
| FHLMC | \$ 17,555 | 719 | 0 | 18,274 |
| FNMA | 12,800 | 692 | 0 | 13,492 |
| Collateralized mortgage obligations: | | | | |
| FHLMC | 1,299 | 44 | 0 | 1,343 |
| FNMA | 382 | 15 | 0 | 397 |
| | 32,036 | 1,470 | 0 | 33,506 |
| Other marketable securities: | | | | |
| U.S. Government agency obligations | 117,931 | 218 | (266) | 117,883 |
| Corporate preferred stock | 700 | 0 | (525) | 175 |
| | 118,631 | 218 | (791) | 118,058 |
| | \$ 150,667 | 1,688 | (791) | 151,564 |

The following table indicates amortized cost and estimated fair value of securities available for sale at March 31, 2011 based upon contractual maturity adjusted for scheduled repayments of principal and projected prepayments of principal based upon current economic conditions and interest rates.

| <i>(Dollars in thousands)</i> | Amortized cost | Fair value |
|--|-------------------|---------------|
| Due less than one year | \$ 100,701 | 101,228 |
| Due after one year through five years | 53,672 | 54,288 |
| Due after five years through ten years | 1,863 | 1,952 |
| No stated maturity | 700 | 175 |
| Total | \$ 156,936 | 157,643 |

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

Table of Contents**(9) Allowance for Loan Losses and Credit Quality Information**

The allowance for loan losses is summarized as follows:

| <i>(Dollars in thousands)</i> | Commercial | | | Commercial | |
|---|---------------|-------------|----------|------------|----------|
| | 1-4 Family | Real Estate | Consumer | Business | Total |
| Balance, December 31, 2010 | \$ 2,145 | 24,590 | 924 | 15,169 | 42,828 |
| Provision for losses | 756 | 539 | 147 | 504 | 1,946 |
| Charge-offs | (403) | (7,576) | (52) | (2,308) | (10,339) |
| Recoveries | 0 | 5 | 4 | 509 | 518 |
| Balance, March 31, 2011 | \$ 2,498 | 17,558 | 1,023 | 13,874 | 34,953 |
| Allocated to: | | | | | |
| Specific reserves | \$ 1,578 | 7,501 | 133 | 9,636 | 18,848 |
| General reserves | 920 | 10,057 | 890 | 4,238 | 16,105 |
| Balance, March 31, 2011 | \$ 2,498 | 17,558 | 1,023 | 13,874 | 34,953 |
| Loans receivable at December 31, 2010: | | | | | |
| Individually reviewed for impairment | \$ 6,729 | 45,077 | 299 | 26,855 | 78,960 |
| Collectively reviewed for impairment | 121,806 | 311,314 | 70,304 | 126,184 | 629,608 |
| Ending balance | \$ 128,535 | 356,391 | 70,603 | 153,039 | 708,568 |
| Loans receivable at March 31, 2011: | | | | | |
| Individually reviewed for impairment | \$ 6,113 | 30,371 | 293 | 24,495 | 61,272 |
| Collectively reviewed for impairment | 121,509 | 296,735 | 67,655 | 123,452 | 609,351 |
| Ending balance | \$ 127,622 | 327,106 | 67,948 | 147,947 | 670,623 |

The following table summarizes the amount of classified and unclassified loans at March 31, 2011 and December 31, 2010:

| <i>(Dollars in thousands)</i> | March 31, 2011 | | | December 31, 2010 | | |
|-------------------------------|----------------|--------------|---------|-------------------|--------------|---------|
| | Classified | Unclassified | Total | Classified | Unclassified | Total |
| 1-4 family | \$ 15,096 | 112,526 | 127,622 | 15,623 | 112,912 | 128,535 |
| Commercial real estate: | | | | | | |
| Residential developments | 34,949 | 33,313 | 68,262 | 42,888 | 44,218 | 87,106 |
| Alternative fuels | 10,917 | 18,783 | 29,700 | 11,069 | 20,054 | 31,123 |
| Other | 13,459 | 215,685 | 229,144 | 12,882 | 225,280 | 238,162 |

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| | | | | | | |
|--------------------------|------------|---------|---------|---------|---------|---------|
| Consumer | 292 | 67,656 | 67,948 | 306 | 70,297 | 70,603 |
| Commercial business: | | | | | | |
| Construction/development | 6,207 | 5,319 | 11,526 | 6,683 | 5,117 | 11,800 |
| Banking | 8,223 | 5,829 | 14,052 | 8,223 | 5,830 | 14,053 |
| Other | 16,671 | 105,698 | 122,369 | 20,468 | 106,718 | 127,186 |
| | \$ 105,814 | 564,809 | 670,623 | 118,142 | 590,426 | 708,568 |

Classified loans represent substandard and non-performing loans. Loans classified substandard are loans that are generally inadequately protected by the current net worth and paying capacity of the obligor, or by the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.

The aging of past due loans at March 31, 2011 and December 31, 2010 are summarized as follows:

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| | 30-59 Days Past Due | 60-89 Days Past Due | 90 Days or More Past Due | Total Past Due | Current Loans | Total Loans | Loans 90 Days or More Past Due and Still Accruing |
|-------------------------------|------------------------------|------------------------------|-----------------------------------|----------------------|------------------|----------------|--|
| <i>(Dollars in thousands)</i> | | | | | | | |
| <i>March 31, 2011</i> | | | | | | | |
| 1-4 family | \$ 3,069 | 485 | 2,013 | 5,567 | 122,055 | 127,622 | 441 |
| Commercial real estate: | | | | | | | |
| Residential developments | 351 | 2,776 | 331 | 3,458 | 64,804 | 68,262 | 0 |
| Alternative fuels | 0 | 0 | 4,994 | 4,994 | 24,706 | 29,700 | 0 |
| Other | 326 | 51 | 4,178 | 4,555 | 224,589 | 229,144 | 0 |
| Consumer | 641 | 1 | 238 | 880 | 67,068 | 67,948 | 83 |
| Commercial business: | | | | | | | |
| Construction/development | 0 | 0 | 1,491 | 1,491 | 10,035 | 11,526 | 0 |
| Banking | 0 | 0 | 8,223 | 8,223 | 5,829 | 14,052 | 0 |
| Other | 589 | 75 | 6,971 | 7,635 | 114,734 | 122,369 | 0 |
| | \$ 4,976 | 3,388 | 28,439 | 36,803 | 633,820 | 670,623 | 524 |
| <i>December 31, 2010</i> | | | | | | | |
| 1-4 family | \$ 2,313 | 695 | 3,500 | 6,508 | 122,027 | 128,535 | 178 |
| Commercial real estate: | | | | | | | |
| Residential developments | 444 | 3,899 | 15,523 | 19,866 | 67,240 | 87,106 | 0 |
| Alternative fuels | 0 | 0 | 4,994 | 4,994 | 26,129 | 31,123 | 0 |
| Other | 75 | 264 | 3,914 | 4,253 | 233,909 | 238,162 | 0 |
| Consumer | 446 | 163 | 207 | 816 | 69,787 | 70,603 | 0 |
| Commercial business: | | | | | | | |
| Construction/development | 0 | 0 | 4,809 | 4,809 | 6,991 | 11,800 | 0 |
| Banking | 0 | 0 | 8,223 | 8,223 | 5,830 | 14,053 | 0 |
| Other | 311 | 45 | 7,876 | 8,232 | 118,954 | 127,186 | 576 |
| | \$ 3,589 | 5,066 | 49,046 | 57,701 | 650,867 | 708,568 | 754 |

Impaired loans include loans that are non-performing (non-accruing) and loans that have been modified in a troubled

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debt restructuring. The following table summarizes impaired loans and related allowances as of March 31, 2011 and December 31, 2010:

| <i>(Dollars in thousands)</i> | Recorded Investment | Unpaid Principal Balance | March 31, 2011 | | Interest Income Recognized |
|---|------------------------|--------------------------------|----------------------|-----------------------------------|----------------------------------|
| | | | Related Allowance | Average Recorded Investment | |
| Loans with no related allowance recorded: | | | | | |
| 1-4 family | \$ 1,372 | 1,372 | 0 | 686 | 20 |
| Commercial real estate: | | | | | |
| Residential developments | 5,879 | 5,879 | 0 | 2,940 | 73 |
| Alternative fuels | 0 | 0 | 0 | 0 | 0 |
| Other | 655 | 655 | 0 | 328 | 4 |
| Consumer | 40 | 40 | 0 | 20 | 0 |
| Commercial business: | | | | | |
| Construction/development | 346 | 346 | 0 | 173 | 2 |
| Banking | 0 | 0 | 0 | 0 | 0 |
| Other | 643 | 643 | 0 | 322 | 15 |
| Loans with an allowance recorded: | | | | | |
| 1-4 family | 4,741 | 4,741 | 1,578 | 2,371 | 41 |
| Commercial real estate: | | | | | |
| Residential developments | 12,895 | 12,895 | 2,784 | 6,448 | 110 |
| Alternative fuels | 4,995 | 4,995 | 2,728 | 2,498 | 0 |
| Other | 5,947 | 6,902 | 1,989 | 2,974 | 14 |
| Consumer | 253 | 253 | 133 | 127 | 3 |
| Commercial business: | | | | | |
| Construction/development | 3,986 | 3,986 | 1,495 | 1,992 | 3 |
| Banking | 8,223 | 8,223 | 5,535 | 4,112 | 0 |
| Other | 11,297 | 11,849 | 2,606 | 5,649 | 75 |
| Total: | | | | | |
| 1-4 family | 6,113 | 6,113 | 1,578 | 3,057 | 61 |
| Commercial real estate: | | | | | |
| Residential developments | 18,774 | 18,774 | 2,784 | 9,387 | 183 |
| Alternative fuels | 4,995 | 4,995 | 2,728 | 2,498 | 0 |
| Other | 6,602 | 7,557 | 1,989 | 3,301 | 18 |
| Consumer | 293 | 293 | 133 | 147 | 3 |
| Commercial business: | | | | | |
| Construction/development | 4,332 | 4,332 | 1,495 | 2,166 | 5 |
| Banking | 8,223 | 8,223 | 5,535 | 4,112 | 0 |
| Other | 11,940 | 12,492 | 2,606 | 5,970 | 90 |
| | \$ 61,272 | 62,779 | 18,848 | 30,637 | 360 |

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| <i>(Dollars in thousands)</i> | Recorded Investment | December 31, 2010 Unpaid Principal Balance | Related Allowance |
|---|------------------------|---|----------------------|
| Loans with no related allowance recorded: | | | |
| 1-4 family | \$ 932 | 932 | 0 |
| Commercial real estate: | | | |
| Residential developments | 6,486 | 6,486 | 0 |
| Alternative fuels | 0 | 0 | 0 |
| Other | 119 | 119 | 0 |
| Consumer | 104 | 104 | 0 |
| Commercial business: | | | |
| Construction/development | 99 | 99 | 0 |
| Banking | 0 | 0 | 0 |
| Other | 397 | 397 | 0 |
| Loans with an allowance recorded: | | | |
| 1-4 family | 5,797 | 5,797 | 994 |
| Commercial real estate: | | | |
| Residential developments | 27,147 | 27,147 | 9,673 |
| Alternative fuels | 4,994 | 4,994 | 2,441 |
| Other | 6,331 | 7,287 | 1,148 |
| Consumer | 195 | 195 | 76 |
| Commercial business: | | | |
| Construction/development | 4,809 | 4,809 | 2,668 |
| Banking | 8,223 | 8,223 | 4,985 |
| Other | 13,327 | 13,878 | 3,049 |
| Total: | | | |
| 1-4 family | 6,729 | 6,729 | 994 |
| Commercial real estate: | | | |
| Residential developments | 33,633 | 33,633 | 9,673 |
| Alternative fuels | 4,994 | 4,994 | 2,441 |
| Other | 6,450 | 7,406 | 1,148 |
| Consumer | 299 | 299 | 76 |
| Commercial business: | | | |
| Construction/development | 4,908 | 4,908 | 2,668 |
| Banking | 8,223 | 8,223 | 4,985 |
| Other | 13,724 | 14,275 | 3,049 |
| | \$ 78,960 | 80,467 | 25,034 |

At March 31, 2011 and December 31, 2010, non-accruing loans totaled \$49.1 million and \$68.1 million, respectively, for which the related allowance for loan losses was \$17.2 million and \$25.0 million, respectively. Non-accruing loans for which no specific allowance has been recorded because management determined that the value of the collateral was sufficient to repay the loan totaled \$7.0 million and \$8.1 million, respectively.

The non-accrual loans at March 31, 2011 and December 31, 2010 are summarized as follows:

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| <i>(Dollars in thousands)</i> | March 31, 2011 | December 31, 2010 |
|-------------------------------|-------------------|----------------------|
| 1-4 family | \$ 3,399 | \$ 4,844 |
| Commercial real estate: | | |
| Residential developments | 10,674 | 25,980 |
| Alternative fuels | 4,994 | 4,994 |
| Other | 5,941 | 5,763 |
| Consumer | 245 | 224 |
| Commercial business: | | |
| Construction/development | 4,332 | 4,907 |
| Banking | 8,223 | 8,223 |
| Other | 11,274 | 13,139 |
| | \$ 49,082 | \$ 68,074 |

At March 31, 2011 and December 31, 2010 there were loans included in loans receivable, net, with terms that had been modified in a troubled debt restructuring totaling \$21.4 million and \$19.3 million, respectively. For the loans that were restructured in the first quarter of 2011, \$2.5 million were classified but performing and \$7.3 million were non-performing at March 31, 2011.

The following table summarizes troubled debt restructurings at March 31, 2011 and December 31, 2010:

| <i>(Dollars in thousands)</i> | March 31, 2011 | December 31, 2010 |
|-------------------------------|-------------------|-------------------------|
| Commercial real estate | \$ 14,752 | 14,871 |
| Commercial business | 3,070 | 1,756 |
| 1-4 family | 3,464 | 2,589 |
| Consumer | 143 | 75 |
| | \$ 21,429 | 19,291 |

There were no material commitments to lend additional funds to customers whose loans were restructured or classified as nonaccrual at March 31, 2011 or December 31, 2010.

(10) Investment in Mortgage Servicing Rights

A summary of mortgage servicing activity is as follows:

| <i>(Dollars in thousands)</i> | Three months ended March 31, 2011 | Twelve months ended December 31, 2010 | Three months ended March 31, 2010 |
|-------------------------------|--|--|--|
| Mortgage servicing rights: | | | |
| Balance, beginning of period | \$ 1,586 | 1,315 | 1,315 |
| Originations | 87 | 753 | 150 |
| Amortization | (98) | (482) | (109) |
| Balance, end of period | 1,575 | 1,586 | 1,356 |

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| | | | | |
|---|----|-------|-------|-------|
| Fair value of mortgage servicing rights | \$ | 2,636 | 2,263 | 2,357 |
| | | 17 | | |

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All of the loans being serviced were single family loans under the FNMA mortgage-backed security program or the individual loan sale program. The following is a summary of the risk characteristics of the loans being serviced at March 31, 2011.

| <i>(Dollars in thousands)</i> | Loan Principal Balance | Weighted Average Interest Rate | Weighted Average Remaining Term | Number of Loans |
|----------------------------------|------------------------------|---|--|--------------------|
| Original term 30 year fixed rate | \$221,928 | 5.22% | 300 | 1,904 |
| Original term 15 year fixed rate | 100,761 | 4.66 | 124 | 1,493 |
| Adjustable rate | 640 | 3.08 | 303 | 8 |

The gross carrying amount of mortgage servicing rights and the associated accumulated amortization at March 31, 2011 is presented in the following table. Amortization expense for mortgage servicing rights was \$98,000 and \$109,000 for the three months ended March 31, 2011 and 2010, respectively.

| <i>(Dollars in thousands)</i> | Gross Carrying Amount | Accumulated Amortization | Unamortized Intangible Assets |
|-------------------------------|-----------------------------|-----------------------------|-------------------------------------|
| Mortgage servicing rights | \$ 4,140 | (2,565) | 1,575 |
| Total | \$ 4,140 | (2,565) | 1,575 |

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

| <i>(Dollars in thousands)</i> | Mortgage Servicing Rights |
|-------------------------------|---------------------------------|
| Year ending December 31, | |
| 2011 | \$268 |
| 2012 | 326 |
| 2013 | 307 |
| 2014 | 277 |
| 2015 | 230 |
| Thereafter | 167 |

Projections of amortization are based on existing asset balances and the existing interest rate environment as of March 31, 2011. The Company's actual experience may be significantly different depending upon changes in mortgage interest rates and other market conditions.

(11) Loss per Common Share

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

| | Three months ended March 31, 2011 | 2010 |
|--|--------------------------------------|-----------|
| Weighted average number of common shares outstanding used in basic earnings per common share calculation | 3,816,686 | 3,736,852 |
| Net dilutive effect of: | | |

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| | | |
|--|-------------|-------------|
| Options | 0 | 0 |
| Restricted stock awards | 0 | 0 |
| Weighted average number of shares outstanding adjusted for effect of dilutive securities | 3,816,686 | 3,736,852 |
| Loss available to common shareholders | \$ (31,818) | (2,287,581) |
| Basic loss per common share | \$ (0.01) | (0.61) |
| Diluted loss per common share | \$ (0.01) | (0.61) |

At March 31, 2011 and 2010, there were 125,647 and 186,145 common share equivalents outstanding,

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respectively, that are not included in the calculation of diluted earnings per share as they are anti-dilutive.

(12) Regulatory Capital and Regulatory Oversight

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

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 March 31, 2011, that the Bank meets all capital adequacy requirements to which it is subject and that based upon the Bank's capital calculations at March 31, 2011 and other conditions consistent with the Prompt Corrective Actions Provisions of the OTS regulations, the Bank would be categorized as well capitalized.

On March 31, 2011, the Bank's tangible assets and adjusted total assets were \$877.7 million and its risk-weighted assets were \$665.8 million. The following table presents the Bank's capital amounts and ratios at March 31, 2011 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 ⁽¹⁾ | Amount | Percent of Assets ⁽¹⁾ | Amount | Percent of Assets ⁽¹⁾ | Amount | Percent of Assets ⁽¹⁾ |
| <i>(Dollars in thousands)</i> | | | | | | | | |
| Bank stockholder's equity | \$ 68,610 | | | | | | | |
| Less: | | | | | | | | |
| Net unrealized gains on certain securities available for sale | (1,020) | | | | | | | |
| Disallowed servicing and tax assets | 0 | | | | | | | |
| Tier I or core capital | 67,590 | | | | | | | |
| Tier I capital to adjusted total assets | | 7.70% | \$ 35,108 | 4.00% | \$ 32,482 | 3.70% | \$ 43,885 | 5.00% |
| Tier I capital to risk-weighted assets | | 10.15% | \$ 26,633 | 4.00% | \$ 40,957 | 6.15% | \$ 39,950 | 6.00% |
| Plus: | | | | | | | | |
| Allowable allowance for loan losses | 8,323 | | | | | | | |
| Risk-based capital | \$ 75,913 | | \$ 53,266 | | \$ 22,647 | | \$ 66,583 | |

| | | | | |
|--|--------|-------|-------|--------|
| Risk-based capital to risk-weighted assets | 11.40% | 8.00% | 3.40% | 10.00% |
|--|--------|-------|-------|--------|

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

The Bank entered into a written Supervisory Agreement with its primary regulator, the OTS, effective February 22, 2011 that primarily relates to the Bank's financial performance and credit quality issues. This agreement replaced the prior memorandum of understanding that the Bank entered into with the OTS on December 9, 2009. In accordance with the Supervisory Agreement, the Bank must submit a two year business plan that the OTS may make comments upon, and require revisions to. The Bank must operate within the parameters of the final business plan and is required to monitor and submit periodic reports on its compliance with the plan. The Bank must also submit a problem asset reduction plan that the OTS may make comments upon, and require revisions to. The Bank must operate within the parameters of the final problem asset plan and is required to monitor and submit periodic reports on its compliance with the plan. The Bank must also revise its loan modification policies and its program for identifying, monitoring and controlling risk associated with concentrations of credit, and improve the documentation of the allowance for loan and lease losses. In addition, without the consent of the OTS, the Bank may not declare or pay any cash dividends,

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materially increase the total assets of the Bank, enter into any new contractual arrangement or renew or extend any existing arrangement related to compensation or benefits with any directors or officer, make any golden parachute payments, or enter into any significant contracts with a third party service provider.

The Company also entered into a written Supervisory Agreement with the OTS effective February 22, 2011. This agreement replaced the prior memorandum of understanding that the Company entered into with the OTS on December 9, 2009. By May 31, 2011, in accordance with the Supervisory Agreement, the Company must submit a capital plan to the OTS through December 31, 2012 that the OTS may make comments upon, and to which it may require revisions. The Company must operate within the parameters of the final capital plan and is required to monitor and submit periodic reports on its compliance with the plan. In addition, without the consent of the OTS, the Company may not incur or issue any debt, guarantee the debt of any entity, declare or pay any cash dividends or repurchase any of the Company's capital stock, enter into any new contractual arrangement or renew or extend any existing arrangement related to compensation or benefits with any directors or officer, or make any golden parachute payments.

The Bank has been informed by the OTS that it intends to impose an Individual Minimum Capital Requirement (IMCR) for the Bank. An IMCR requires a bank to establish and maintain levels of capital greater than those generally required for a bank to be classified as well-capitalized. The Bank has not been informed by the OTS of the timing or capital levels that may be required.

(13) *Commitments and Contingencies*

The Bank issued standby letters of credit which guarantee the performance of customers to third parties. The standby letters of credit issued and available at March 31, 2011 were approximately \$2.5 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.

(14) *Business Segments*

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

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

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

| <i>(Dollars in thousands)</i> | Home Federal Savings Bank | Other | Eliminations | Consolidated Total |
|--|------------------------------|---------|--------------|-----------------------|
| At or for the quarter ended March 31, 2011: | | | | |
| Interest income external customers | \$ 10,714 | 0 | 0 | 10,714 |
| Non-interest income external customers | 1,788 | 0 | 0 | 1,788 |
| Loss on limited partnerships | (2) | 0 | 0 | (2) |
| Intersegment interest income | 0 | 1 | (1) | 0 |
| Intersegment non-interest income | 43 | 688 | (731) | 0 |
| Interest expense | 3,270 | 0 | (1) | 3,269 |
| Amortization of mortgage servicing rights, net | 98 | 0 | 0 | 98 |
| Other non-interest expense | 6,463 | 274 | (43) | 6,694 |
| Income tax expense | 76 | 0 | 0 | 76 |
| Net income | 690 | 415 | (688) | 417 |
| Total assets | 878,686 | 70,563 | (70,493) | 878,756 |
| At or for the quarter ended March 31, 2010: | | | | |
| Interest income external customers | \$ 12,904 | 0 | 0 | 12,904 |
| Non-interest income external customers | 1,582 | 0 | 0 | 1,582 |
| Loss on limited partnerships | (8) | 0 | 0 | (8) |
| Intersegment interest income | 0 | 1 | (1) | 0 |
| Intersegment non-interest income | 43 | (1,672) | 1,629 | 0 |
| Interest expense | 4,944 | 0 | (1) | 4,943 |
| Amortization of mortgage servicing rights, net | 109 | 0 | 0 | 109 |
| Other non-interest expense | 5,748 | 203 | (43) | 5,908 |
| Income tax benefit | (1,143) | (25) | 0 | (1,168) |
| Net loss | (1,670) | (1,849) | 1,672 | (1,847) |
| Total assets | 1,027,274 | 98,203 | (97,001) | 1,028,476 |

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, other reports filed by the Company with the Securities and Exchange Commission may contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements are often identified by such forward-looking terminology as expect, intent, look, believe, anticipate, estimate, project, seek, may, will, would, could, should, trend, target, and goal or similar statements. Such terms and include, but are not limited to, those relating to the adequacy and amount of available liquidity and capital resources to the Bank, the Company's liquidity and capital requirements, changes in the size of the Bank's loan portfolio, the recovery of the valuation allowance on deferred tax assets, the amount and mix of the Bank's non-performing assets and the adequacy of the allowance therefor, future losses on non-performing assets, the amount of interest-earning assets, the amount and mix of brokered and other deposits (including the Company's ability to renew brokered deposits), the availability of alternate funding sources, the payment of dividends, the future outlook for the Company, and the Company's and the Bank's compliance with regulatory standards generally (including the Bank's status as well-capitalized), and supervisory agreements, individual capital requirements or other supervisory directives or requirements to which the Company or the Bank are expressly subject, specifically. 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, possible legislative and regulatory changes, including changes in the degree and manner of regulatory supervision, the ability of the Company and the Bank to establish and adhere to plans and policies relating to, among other things, capital, business, non-performing assets, loan modifications, documentation of loan loss allowance and concentrations of credit that are satisfactory to the OTS in accordance with the terms of the Company and Bank supervisory agreements and to otherwise manage the operations of the Company and the Bank to ensure compliance with other requirements set forth in the supervisory agreements; the ability of the Company and the Bank to obtain required consents from the OTS under the supervisory agreements or other directives; 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; collateral advance rates and policies of the FHLB; costs associated with alternate funding sources; 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 sections of the Company's Annual Report on Form 10-K for the year ended December 31, 2010 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, Federal Home Loan Bank (FHLB) advances, and Federal Reserve Bank (FRB) borrowings. The difference between the average rate of interest earned on assets and the average rate paid on liabilities is the interest rate spread. Net interest income is produced when interest-earning assets equal or exceed interest-bearing liabilities and there is a positive interest rate spread. Net interest income and net interest rate spread are affected by changes in interest rates, the volume and mix of interest-earning assets and interest-bearing liabilities, and the level of non-performing assets. The Company's net income is also affected by the generation of non-interest income, which consists primarily of gains or losses from the sale of securities, gains from the sale of loans, fees for servicing mortgage loans, and the generation of fees and service charges on deposit accounts. The Bank incurs expenses in addition to interest expense in the form of salaries and benefits, occupancy expenses, provisions for loan losses and amortization of mortgage servicing assets.

The earnings of financial institutions, such as the Bank, are also significantly affected by prevailing economic and

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competitive conditions, particularly changes in interest rates, government monetary and fiscal policies, and regulations of various regulatory authorities. Lending activities are influenced by the demand for and supply of business credit, single family and commercial properties, competition among lenders, the level of interest rates and the availability of funds. Deposit flows and costs of deposits are influenced by prevailing market rates of interest on competing investments, account maturities and the levels of personal income and savings.

Beginning with the onset of the 2007 recession and the Company's 2008 fiscal year, the Company's commercial business and commercial real estate loan portfolios have required significant allowances and charge offs due primarily to decreases in the estimated value of the underlying collateral supporting the loans, as many of these loans were made to borrowers in or associated with the real estate industry. The decrease in the estimated collateral value is primarily the result of reduced demand for real estate, particularly as it relates to single-family and commercial land developments. More stringent lending standards implemented by the mortgage industry in recent years have made it more difficult for some borrowers with marginal credit to qualify for a mortgage. This decrease in available credit and the overall weakness in the economy over the past several years reduced the demand for single family homes and the values of existing properties and developments where the Company's commercial loan portfolio has concentrations. Consequently, our level of non-performing assets and the related provision for loan losses increased significantly in the past several years, relative to periods before 2008. The increased levels of non-performing assets, related provisions for loan losses and write offs of or allowances against goodwill and deferred taxes arising from adverse results of operations, were the primary reasons for the net losses incurred by the Company in each of the years 2008 through 2010.

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, assumptions and other factors used.

Allowance for Loan Losses and Related Provision

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

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. Because of the size of some loans, changes in estimates can have a significant impact on the loan loss provision. The allowance is allocated to individual loan categories based upon the relative risk characteristics of the loan portfolios and the actual loss experience. The Company increases its allowance for loan

losses by charging the provision for loan losses against income. The methodology for establishing the allowance for loan losses takes into consideration probable losses that have been identified in

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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 date, future conditions may differ substantially from those anticipated in determining the allowance for loan losses and adjustments may be required in the future.

Income Taxes

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

The Company maintains significant net deferred tax assets for deductible temporary differences, the largest of which relates to the allowance for loan and real estate losses and net operating loss carry forwards. For income tax purposes, only net charge-offs and certain specific reserves are deductible, not the entire provision for loan losses. Under generally accepted accounting principles, a valuation allowance is required to be recognized if it is more likely than not that the deferred tax asset will not be realized. The determination of the realizability of the deferred tax assets is highly subjective and dependent upon management's judgment and evaluation of both positive and negative evidence, including the forecasts of future income, tax planning strategies and assessments of the current and future economic and business conditions. The Company considers both positive and negative evidence regarding the ultimate realizability of deferred tax assets. Positive evidence includes the ability to implement tax planning strategies to accelerate taxable income recognition and the probability that taxable income will be generated in future periods. Negative evidence includes the Company's cumulative loss in the prior three year period, current financial performance, and the general business and economic trends. At March 31, 2011, the Company recorded a valuation allowance against the entire deferred tax asset balance. This determination was based primarily upon the existence of a three year cumulative loss position that is primarily attributable to significant provisions for loan losses incurred during the last three years. The creation of the valuation allowance, although it increased tax expense and similarly reduced tangible book value, does not have an effect on the Company's cash flows, and may be recoverable in subsequent periods if the Company were to realize certain sustained future taxable income. It is possible that future conditions may differ substantially from those anticipated in determining the need for a valuation allowance on deferred tax assets and adjustments may be required in the future.

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

RESULTS OF OPERATIONS FOR FIRST QUARTER ENDED MARCH 31, 2011 COMPARED TO FIRST QUARTER ENDED MARCH 31, 2010*Net Income*

Net income for the first quarter of 2011 was \$0.4 million, an improvement of \$2.2 million compared to a net loss of \$1.8 million for the first quarter of 2010. Net loss available to common shareholders was \$32,000 for the first quarter of 2011, an improvement of \$2.3 million, or 98.6%, from the net loss available to common shareholders of \$2.3 million for the first quarter of 2010. Diluted loss per common share for the first quarter of 2011 was \$0.01, an improvement of \$0.60 from the diluted loss per common share of \$0.61 for the first quarter of 2010. The improvement in net income was due primarily to a \$4.6 million decrease in the provision for loan losses between the periods that was partially offset by a \$1.2 million increase in income taxes and a \$0.8 million increase in the losses recognized on the sale of real estate owned between the periods.

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Net Interest Income

Net interest income was \$7.4 million for the first quarter of 2011, a decrease of \$0.6 million, or 6.5%, compared to \$8.0 million for the first quarter of 2010. Interest income was \$10.7 million for the first quarter of 2011, a decrease of \$2.2 million, or 17.0%, from \$12.9 million for the first quarter of 2010. Interest income decreased between the periods primarily because of a \$143 million decrease in average interest-earning assets between the periods. Average interest earning assets decreased between the periods primarily because of a decrease in the commercial loan portfolio, which occurred because of declining loan demand and the Company's focus on improving credit quality, reducing loan concentrations, managing interest rate risk and improving capital ratios. The average yield earned on interest-earning assets was 5.21% for the first quarter of 2011, a decrease of 15 basis points from the 5.36% average yield for the first quarter of 2010.

Interest expense was \$3.3 million for the first quarter of 2011, a decrease of \$1.6 million, or 33.9%, compared to \$4.9 million for the first quarter of 2010. Interest expense decreased primarily because of a \$124 million decrease in the average outstanding balance of interest-bearing liabilities and noninterest bearing deposits between the periods. The decrease in average interest-bearing liabilities is primarily the result of a decrease in the outstanding borrowings and brokered certificates of deposits between the periods. The decrease in borrowings and brokered deposits between the periods was the result of using the proceeds from loan principal payments to fund maturing borrowings and brokered deposits. Interest expense also decreased because of the lower interest rates paid on money market accounts and certificates of deposits. The decreased rates were the result of the low interest rate environment that continued to exist during the first quarter of 2011. The average interest rate paid on interest-bearing liabilities was 1.66% for the first quarter of 2011, a decrease of 51 basis points from the 2.17% average interest rate paid in the first quarter of 2010.

Net interest margin (net interest income divided by average interest earning assets) for the first quarter of 2011 was 3.62%, an increase of 31 basis points, compared to 3.31% for the first quarter of 2010.

A summary of the Company's net interest margin for the three month periods ended March 31, 2011 and 2010 is as follows:

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| | For the three month period ended | | | | | |
|--|----------------------------------|-----------------------|-------------|-----------------------------|-----------------------|-------------|
| | March 31, 2011 | | | March 31, 2010 | | |
| <i>(Dollars in thousands)</i> | Average Outstanding Balance | Interest Earned/ Paid | Yield/ Rate | Average Outstanding Balance | Interest Earned/ Paid | Yield/ Rate |
| Interest-earning assets: | | | | | | |
| Securities available for sale | \$ 149,928 | 741 | 2.00% | \$ 159,759 | 1,107 | 2.81% |
| Loans held for sale | 1,537 | 17 | 4.49 | 1,785 | 21 | 4.77 |
| Mortgage loans, net | 128,307 | 1,763 | 5.57 | 143,667 | 2,097 | 5.92 |
| Commercial loans, net | 453,694 | 7,095 | 6.34 | 564,322 | 8,453 | 6.07 |
| Consumer loans, net | 68,666 | 1,028 | 6.07 | 80,991 | 1,188 | 5.95 |
| Cash equivalents | 24,444 | 1 | 0.02 | 18,591 | 1 | 0.02 |
| Federal Home Loan Bank stock | 6,692 | 69 | 4.18 | 7,286 | 37 | 2.06 |
| Total interest-earning assets | 833,268 | 10,714 | 5.22 | 976,401 | 12,904 | 5.36 |
| Interest-bearing liabilities and noninterest bearing deposits: | | | | | | |
| NOW accounts | 79,017 | 19 | 0.10 | 98,474 | 22 | 0.09 |
| Savings accounts | 34,676 | 13 | 0.15 | 31,821 | 10 | 0.13 |
| Money market accounts | 113,712 | 214 | 0.76 | 136,800 | 392 | 1.16 |
| Certificates | 254,148 | 1,057 | 1.69 | 243,180 | 1,476 | 2.46 |
| Brokered deposits | 100,801 | 637 | 2.56 | 199,257 | 1,521 | 3.10 |
| Federal Home Loan Bank advances | 119,833 | 1,329 | 4.50 | 132,611 | 1,522 | 4.65 |
| Total interest-bearing liabilities | 702,187 | | | 842,143 | | |
| Noninterest checking | 96,146 | | | 79,635 | | |
| Other noninterest bearing escrow deposits | 1,164 | | | 1,836 | | |
| Total interest-bearing liabilities and noninterest bearing deposits | \$ 799,497 | 3,269 | 1.66 | \$ 923,614 | 4,943 | 2.17 |
| Net interest income | | \$ 7,445 | | | \$ 7,961 | |
| Net interest rate spread | | | 3.56% | | | 3.19% |
| Net interest margin | | | 3.62% | | | 3.31% |

Provision for Loan Losses

The provision for loan losses was \$1.9 million for the first quarter of 2011, a decrease of \$4.6 million, or 70.2%, compared to \$6.5 million for the first quarter of 2010. The provision for loan losses decreased in the first quarter of 2011 primarily because there were fewer decreases in the estimated value of the underlying collateral supporting commercial real estate loans that required specific allowances and there were fewer commercial loan risk rating

downgrades when compared to the first quarter of 2010.

A reconciliation of the Company's allowance for loan losses for the first quarters of 2011 and 2010 is summarized as follows:

| <i>(Dollars in thousands)</i> | 2011 | 2010 |
|-------------------------------|-----------|-----------|
| Balance at January 1, | \$ 42,828 | \$ 23,811 |
| Provision | 1,946 | 6,533 |
| Charge offs: | | |
| One-to-four family | (403) | (51) |
| Consumer | (52) | (306) |
| Commercial business | (2,308) | (61) |
| Commercial real estate | (7,576) | (660) |
| Recoveries | 518 | 18 |
| Balance at March 31, | \$ 34,953 | \$ 29,284 |
| General allowance | \$ 16,105 | \$ 12,058 |
| Specific allowance | 18,848 | 17,226 |
| | \$ 34,953 | \$ 29,284 |

Charge offs increased in the first quarter of 2011, primarily because of four lending relationships totaling \$9.3

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million where the collateral was moved to real estate owned or repossessed assets during the quarter and the previously established specific reserves were charged off.

Non-Interest Income

Non-interest income was \$1.8 million for the first quarter of 2011, an increase of \$0.2 million, or 13.5%, from \$1.6 million for the first quarter of 2010. Gain on sales of loans increased \$181,000 between the periods due to an increase in the gains recognized on the sale of commercial government guaranteed loans that was partially offset by a decrease in the gain recognized on the sale of single family loans due to a decrease in single family loan originations between the periods. Fees and service charges increased \$82,000 between the periods primarily because of an increase in late fees and overdraft charges. Other non-interest income decreased \$33,000 between the periods primarily because of decreased rental income on other real estate owned. Loan servicing fees decreased \$18,000 between the periods primarily because of a decrease in the number of commercial loans that are being serviced for others.

Non-Interest Expense

Non-interest expense was \$6.8 million for the first quarter of 2011, an increase of \$0.8 million, or 12.9%, from \$6.0 million for the first quarter of 2010. The loss on real estate owned increased \$808,000 between the periods from a gain in the first quarter of 2010 to a loss in the first quarter of 2011. Compensation expense increased \$111,000 primarily because of increased personnel in the commercial loan recovery area. Other non-interest expense increased \$83,000 between the periods primarily because of increased legal expenses related to non-performing assets and regulatory compliance. Deposit insurance expense decreased \$113,000 primarily because of the decrease in outstanding brokered deposits between the periods. Occupancy expense decreased \$91,000 primarily because of a decrease in depreciation expense. Data processing expense decreased \$23,000 primarily due to a decrease in debit card expenses as a result of changing vendors in the fourth quarter of 2010.

Income Taxes

The effect of income taxes changed \$1.2 million between the periods from a benefit of \$1.1 million in the first quarter of 2010 to an expense of \$76,000 in the first quarter of 2011. The Company continues to record a valuation reserve against the entire deferred tax asset balance at March 31, 2011. Since the valuation reserve is established against the entire deferred tax asset balance, the only amount included as income tax expense for the first quarter of 2011 relates to the taxes on the change in the fair market value of the available for sale investment portfolio.

Net Loss Available to Common Shareholders

The net loss available to common shareholders was \$32,000 for the first quarter of 2011, a decreased loss of \$2.3 million from the \$2.3 million net loss available to common shareholders in the first quarter of 2010. The net loss available to common shareholders decreased primarily because of the change in the net income (loss) between the periods. The Company deferred the February 15, 2011 regular quarterly cash dividend payment and has determined that it will defer the May 15, 2011 regular quarterly cash dividend payment on its Fixed Rate Cumulative Perpetual Preferred Stock, Series A issued to the United States Treasury Department as part of the TARP Capital Purchase Program. The deferred dividend payments will continue to be accrued for payment in the future and will be reported for the deferral period as a preferred dividend requirement that is deducted from income (loss) available to common shareholders for financial statement purposes.

FINANCIAL CONDITION***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 March 31, 2011 and December 31, 2010.

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| <i>(Dollars in thousands)</i> | March 31, 2011 | December 31, 2010 |
|---|-------------------|-------------------------|
| Non-Accruing Loans: | | |
| One-to-four family real estate | \$ 3,399 | \$ 4,844 |
| Commercial real estate | 21,609 | 36,737 |
| Consumer | 245 | 224 |
| Commercial business | 23,829 | 26,269 |
| Total | 49,082 | 68,074 |
| Foreclosed and Repossessed Assets: | | |
| One-to-four family real estate | 1,640 | 972 |
| Consumer | 14 | 14 |
| Commercial real estate | 19,829 | 15,409 |
| Total non-performing assets | \$ 70,565 | \$ 84,469 |
| Total as a percentage of total assets | 8.03% | 9.59% |
| Total non-performing loans | \$ 49,082 | \$ 68,074 |
| Total as a percentage of total loans receivable, net | 7.74% | 10.25% |
| Allowance for loan loss to non-performing loans | 71.21% | 62.91% |
| Delinquency Data: | | |
| Delinquencies ⁽¹⁾ | | |
| 30+ days | \$ 4,940 | \$ 4,021 |
| 90+ days | 178 | 754 |
| Delinquencies as a percentage of Loan and lease portfolio ⁽¹⁾ | | |
| 30+ days | 0.76% | 0.59% |
| 90+ days | 0.03% | 0.11% |

(1) Excludes non-accrual loans.

The Company had specific reserves established against the above non-accruing loans of \$17.2 million and \$25.0 million at March 31, 2011 and December 31, 2010, respectively.

Total non-performing assets were \$70.6 million at March 31, 2011, a decrease of \$13.9 million, or 16.5%, from \$84.5 million at December 31, 2010. Non-performing loans decreased \$19.0 million and foreclosed and repossessed assets increased \$5.1 million during the first quarter of 2011. The non-performing loan and foreclosed and repossessed asset activity for the first quarter of 2011 was as follows:

(Dollars in thousands)

Non-performing loans

| | |
|------------------------------|-----------|
| January 1, 2011 | \$ 68,074 |
| Classified as non-performing | 2,445 |
| Charge offs | (10,339) |

| | |
|----------------------------------|-----------|
| Principal payments received | (939) |
| Classified as accruing | (3,928) |
| Transferred to real estate owned | (6,231) |
| March 31, 2011 | \$ 49,082 |

Foreclosed and repossessed assets

| | |
|---------------------------------------|-----------|
| January 1, 2011 | \$ 16,395 |
| Transferred from non-performing loans | 6,231 |
| Other foreclosures/repossessions | 0 |
| Real estate sold | (1,054) |
| Net gain on sale of assets | 81 |
| Write downs | (170) |
| March 31, 2011 | \$ 21,483 |

Of the \$10.3 million in charge offs recorded during the first quarter of 2011, \$9.3 million related to the charge offs on four lending relationships where the collateral was moved to real estate owned or repossessed assets during the quarter and the previously established specific reserves were charged off.

The following table summarizes the number of lending relationships and industry of commercial business loans

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(the largest category of non-performing loans) that were non-performing at March 31, 2011 and December 31, 2010.

| <i>(Dollars in thousands)</i> | | Principal Amount of Loans March 31, 2011 | | Principal Amount of Loans December 31, 2010 |
|-------------------------------|----|--|----|---|
| Industry Type | # | | # | |
| Construction/development | 5 | \$ 6,205 | 6 | \$ 9,148 |
| Finance | 1 | 244 | 1 | 248 |
| Retail | 3 | 3,129 | 1 | 2,504 |
| Banking | 2 | 8,223 | 2 | 8,223 |
| Entertainment | 1 | 309 | 1 | 315 |
| Utilities | 1 | 4,598 | 1 | 4,614 |
| Restaurant | 3 | 1,121 | 4 | 1,217 |
| | 16 | \$ 23,829 | 16 | \$ 26,269 |

The Company had specific reserves established against the above commercial business loans of \$9.3 million and \$10.7 million, respectively, at March 31, 2011 and December 31, 2010.

The following table summarizes the number of lending relationships and types of commercial real estate loans that were non-performing at March 31, 2011 and December 31, 2010.

| <i>(Dollars in thousands)</i> | | Principal Amount of Loans March 31, 2011 | | Principal Amount of Loans December 31, 2010 |
|-------------------------------|-----------------------|--|-----------------------|---|
| Property Type | # of relationships | | # of relationships | |
| Residential developments | 4 | \$ 10,732 | 9 | \$ 23,661 |
| Single family homes | 2 | 296 | 3 | 2,673 |
| Alternative fuel plants | 1 | 4,994 | 1 | 4,994 |
| Shopping centers/retail | 2 | 1,036 | 3 | 1,099 |
| Restaurants/bar | 1 | 614 | 1 | 635 |
| Office buildings | 2 | 3,937 | 1 | 3,675 |
| | 12 | \$ 21,609 | 18 | \$ 36,737 |

The Company had specific reserves established against the above commercial real estate loans of \$6.9 million and \$13.3 million, respectively, at March 31, 2011 and December 31, 2010. The decrease in the non-performing commercial real estate loans is due primarily to the \$10.3 million in charge offs and \$6.2 million in loans that were foreclosed on during the quarter and moved to other real estate owned.

Dividends

The declaration of dividends is subject to, among other things, the Company's financial condition and results of operations, the Bank's compliance with its regulatory capital requirements, tax considerations, industry standards, economic conditions, regulatory restrictions, general business practices and other factors. Under the Bank Supervisory Agreement, no dividends can be declared or paid by the Bank to the Company without prior regulatory approval. The payment of dividends by the Company is dependent upon the Company having adequate cash or other assets that can be converted to cash to pay dividends to its stockholders and, under the Company Supervisory Agreement, the Company may not declare or pay any cash dividends, or purchase or redeem any capital stock, without prior notice to,

and consent of, the OTS. The Company suspended the dividend payments to common stockholders in the fourth quarter of 2008 due to the net operating losses experienced and the challenging economic environment. The Company deferred the February 15, 2011 regular quarterly cash dividend and has determined that it will defer the May 15, 2011 regular quarterly cash dividend on the preferred stock issued to the United States Treasury Department as part of the TARP Capital Purchase Program.

LIQUIDITY AND CAPITAL RESOURCES

For the quarter ended March 31, 2011, the net cash provided by operating activities was \$6.8 million. The Company collected \$33.8 million in principal repayments and maturities on securities during the quarter. It purchased \$40.0 million of investment securities, redeemed \$0.3 million in FHLB stock, received \$1.1 million in proceeds from the sale of real estate, and received \$19.2 million related to a decrease in net loans receivable. The Company had a net increase in deposit balances of \$4.8 million during the quarter and received \$0.6 million in

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customer escrows. It also paid off borrowings of \$7.5 million.

The Company has certificates of deposits with outstanding balances of \$177.4 million that come due over the next 12 months, of which \$48.3 million were obtained from brokers. Based upon past experience, management anticipates that the majority of the non-brokered deposits will renew for another term. The Company believes that non-brokered deposits which do not renew will be replaced with deposits from other customers or brokers. FHLB advances, Federal Reserve borrowings, or proceeds from the sale of securities could also be used to replace unanticipated outflows of non-brokered deposits.

The Company has deposits of \$57.6 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, however, management does not anticipate that these deposits will be withdrawn from the Bank over the next twelve months. If these deposits were to be withdrawn, the Company believes they would be replaced with deposits from other customers or brokers. FHLB advances, Federal Reserve borrowings or proceeds from the sale of securities could also be used to replace unanticipated outflows of large checking and money market deposits.

The Company has \$45.0 million in advances with the FHLB that mature during the next twelve months. The Company has \$70.0 million of FHLB advances that mature beyond March 31, 2012 that have call features that can be exercised by the FHLB during the next twelve months. 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. Under the Company Supervisory Agreement, the Company may not incur or issue any debt without prior notice to, and the consent of, the OTS. Because FHLB advances are debt of the Bank, they are not affected by the Company's restriction on incurring debt.

The primary source of cash for HMN is dividends from the Bank and the Bank is restricted under the Bank Supervisory Agreement from paying dividends to the Company without obtaining prior regulatory approval. At March 31, 2011, HMN had \$1.9 million in cash and other assets that could readily be turned into cash. The primary use of cash by HMN is the payment of expenses and dividends on the preferred stock issued to the United States Treasury Department as part of the TARP Capital Purchase Program. The amount of the dividend on the preferred stock accumulates at the rate of \$325,000 per quarter through February 14, 2014 and \$585,000 per quarter thereafter, if the shares of preferred stock are not redeemed. If the accumulated dividends on the preferred stock have not been paid for an aggregate of six quarterly dividend periods or more, whether or not consecutive, the number of directors of the Company automatically will be increased by two, and the holders of the preferred shares (currently the United States Treasury) will have the right to elect two directors to fill the newly created directorships. The Company deferred the February 15, 2011 dividend payment and has determined that it will defer the May 15, 2011 payment. HMN also serves as a source of capital, liquidity and financial support to the Bank. Based on the operating performance of the Bank or other capital demands, HMN may need to raise additional capital. If HMN raises capital through the issuance of additional shares of common stock or other equity securities, it would dilute the ownership interests of existing stockholders and may dilute the per share book value of the Company's common stock. New investors may also have rights, preferences and privileges senior to the Company's current stockholders, which may adversely impact the Company's current stockholders. HMN's ability to raise additional capital, if needed, will depend on conditions in the capital markets at that time, which are outside of the Company's control, and on the Company's financial performance. Accordingly, HMN may not be able to raise additional capital, if needed, on favorable economic, or other terms acceptable to the Company. If HMN cannot raise additional capital when needed, the Company's ability to maintain or expand its operations, its ability to operate without additional regulatory or other restrictions, and its operating results, could be materially adversely affected.

Market Risk

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

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The Company's profitability is affected by fluctuations in interest rates. A sudden and substantial change in interest rates may adversely impact the Company's earnings to the extent that the interest rates borne by assets and liabilities do not change at the same speed, to the same extent, or on the same basis. The Company monitors the projected changes in net interest income that occur if interest rates were to suddenly change up or down. The *Rate Shock Table* located in the Asset/Liability Management section of this report, which follows, discloses the Company's projected changes in net interest income based upon immediate interest rate changes called rate shocks.

The Company utilizes a model that uses the discounted cash flows from its interest-earning assets and its interest-bearing liabilities to calculate the current market value of those assets and liabilities. The model also calculates the changes in market value of the interest-earning assets and interest-bearing liabilities due to different interest rate changes. The following table discloses the projected changes in market value to the Company's interest-earning assets and interest-bearing liabilities based upon incremental 100 basis point changes in interest rates from interest rates in effect on March 31, 2011.

Other than trading portfolio

(Dollars in thousands)

| | Market Value | | | |
|---|--------------|---------|---------|---------|
| Basis point change in interest rates | -100 | 0 | +100 | +200 |
| Total market risk sensitive assets | \$ 862,199 | 849,463 | 835,021 | 819,504 |
| Total market risk sensitive liabilities | 811,797 | 799,526 | 786,135 | 772,290 |
| Off-balance sheet financial instruments | (176) | 0 | 35 | 79 |
| Net market risk | \$ 50,578 | 49,937 | 48,851 | 47,135 |
| Percentage change from current market value | 1.28% | 0.00% | (2.17)% | (5.61)% |

The preceding table was prepared utilizing the model using the following assumptions (the Model Assumptions) regarding prepayment and decay ratios which were determined by management based upon their review of historical prepayment speeds and future prepayment projections. Fixed rate loans were assumed to prepay at annual rates of between 5% to 70%, depending on the note rate and the period to maturity. Adjustable rate mortgages (ARMs) were assumed to prepay at annual rates of between 7% and 45%, depending on the note rate and the period to maturity. Growing Equity Mortgage (GEM) loans were assumed to prepay at annual rates of between 12% and 34% 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 21% and money market accounts were assumed to decay at an annual rate of 23%. Retail non-interest checking accounts and NOW accounts were assumed to decay at an annual rate of 17%. Commercial NOW accounts and MMDA accounts were assumed to decay at annual rates of 17% and 23%, respectively. FHLB advances and callable investments were projected to be called at the first call date where the projected interest rate on similar remaining term instruments exceeded the interest rate on the callable advance or investment.

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

their debt may decrease in the event of a substantial sustained interest rate

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increase.

Asset/Liability Management

The Company's management reviews the impact that changing interest rates will have on its net interest income projected for the twelve months following March 31, 2011 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.

| <i>(Dollars in thousands)</i> | Rate Shock | Projected | |
|-------------------------------|--------------------|--|----------------------|
| | in Basis Points | Change in Net Interest Income | Percentage Change |
| | +200 | \$ 1,062 | 3.70% |
| | +100 | 790 | 2.75 |
| | 0 | 0 | 0.00 |
| | -100 | (1,447) | (5.04) |

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

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

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

To the extent consistent with its interest rate spread objectives, the Bank attempts to manage its interest rate risk and has taken a number of steps to structure 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'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
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principal executive officer and principal financial officer concluded that the Company's disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

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

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

ITEM 1. Legal Proceedings.

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

ITEM 1A. Risk Factors.

See Part I, Item 1.A. of the Company's Annual Report on Form 10-K for the year ended December 31, 2010 for risk factors.

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

None.

ITEM 3. Defaults Upon Senior Securities.

The Company has deferred regular quarterly cash dividend payments on preferred stock issued to the United States Treasury Department as part of the TARP Capital Purchase Program. For additional information on these dividend deferrals, please see the Company's current reports on Form 8-K filed with the Securities and Exchange Commission.

ITEM 4. [Removed and Reserved]

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.

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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: May 5, 2011

/s/ Bradley Krehbiel
Bradley Krehbiel, President
(Principal Executive Officer)

Date: May 5, 2011

/s/ Jon Eberle
Jon Eberle,
Chief Financial Officer
(Principal Financial Officer)
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**HMN FINANCIAL, INC.
INDEX TO EXHIBITS
FOR FORM 10-Q**

| Regulation S-K Exhibit Number | Document Attached Hereto | Reference to Prior Filing or Exhibit Number | Sequential Page Numbering Where Attached Exhibits Are Located in This Form 10-Q Report |
|--|--|---|---|
| 3.1 | Amended and Restated Certificate of Incorporation | *1 | N/A |
| 3.2 | Amended and Restated By-laws | *2 | N/A |
| 4 | Form of Common Stock Certificate | *3 | N/A |
| 10.18 | Description of Retention Awards for Certain Executive Officers | 10.18 | Filed Electronically |
| 10.19 | Supervisory Agreement between HMN Financial, Inc. and the Office of Thrift Supervision | *4 | N/A |
| 10.20 | Supervisory Agreement between Home Federal Savings Bank and the Office of Thrift Supervision | *5 | 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 3.2 to the Company's Quarterly Report on Form 10-Q, as amended, for the period ending September 30, 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).

*4 Incorporated by reference to the same numbered exhibit to the Company's Annual Report on Form 10-K for the period ended December 31, 2011 (File No. 0-24100).

*5 Incorporated by reference to the same numbered exhibit to the Company's Annual Report on Form 10-K for the period ended December 31, 2011 (File No. 0-24100).