

HMN FINANCIAL INC
Form 10-Q
November 06, 2013

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2013

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15 (d) OF 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 No.)

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

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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 (§232.405 of this chapter) 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.

| | |
|-------------------------|---|
| Large accelerated filer | Accelerated filer |
| Non-accelerated filer | (Do not check if a smaller reporting company) Smaller reporting company |

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

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

| Class | Outstanding at October 16, 2013 |
|--------------------------------|---------------------------------|
| Common stock, \$0.01 par value | 4,424,349 |

HMN FINANCIAL, INC.

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

| <i>(Dollars in thousands)</i> | September 30, 2013 (unaudited) | December 31, 2012 |
|---|--------------------------------------|----------------------|
| Assets | | |
| Cash and cash equivalents | \$ 57,652 | 83,660 |
| Securities available for sale: | | |
| Mortgage-backed and related securities (amortized cost \$5,625 and \$9,825) | 5,973 | 10,421 |
| Other marketable securities (amortized cost \$84,800 and \$75,759) | 83,714 | 75,470 |
| | 89,687 | 85,891 |
| Loans held for sale | 1,180 | 2,584 |
| Loans receivable, net | 393,322 | 454,045 |
| Accrued interest receivable | 1,817 | 2,018 |
| Real estate, net | 8,899 | 10,595 |
| Federal Home Loan Bank stock, at cost | 784 | 4,063 |
| Mortgage servicing rights, net | 1,769 | 1,732 |
| Premises and equipment, net | 6,726 | 7,173 |
| Prepaid expenses and other assets | 729 | 1,566 |
| Total assets | \$ 562,565 | 653,327 |
| Liabilities and Stockholders' Equity | | |
| Deposits | \$ 485,921 | 514,951 |
| Federal Home Loan Bank advances | 0 | 70,000 |
| Accrued interest payable | 127 | 247 |
| Customer escrows | 1,328 | 830 |

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| | | | | |
|---|------------|---|----------|---|
| Accrued expenses and other liabilities | 7,813 | | 6,465 | |
| Total liabilities | 495,189 | | 592,493 | |
| Commitments and contingencies | | | | |
| Stockholders' equity: | | | | |
| Serial preferred stock: (\$.01 par value) authorized 500,000 shares; issued shares 26,000 | 25,778 | | 25,336 | |
| Common stock (\$.01 par value): authorized 16,000,000; issued shares 9,128,662 | 91 | | 91 | |
| Additional paid-in capital | 51,638 | | 51,795 | |
| Retained earnings, subject to certain restrictions | 54,488 | | 47,004 | |
| Accumulated other comprehensive loss | (1,094) |) | (49) |) |
| Unearned employee stock ownership plan shares | (2,852) |) | (2,997) |) |
| Treasury stock, at cost 4,735,589 and 4,705,073 shares | (60,673) |) | (60,346) |) |
| Total stockholders' equity | 67,376 | | 60,834 | |
| Total liabilities and stockholders' equity | \$ 562,565 | | 653,327 | |

See accompanying notes to consolidated financial statements.

HMN FINANCIAL, INC. AND SUBSIDIARIES**Consolidated Statements of Comprehensive Income**

(unaudited)

| | Three Months Ended | | Nine Months Ended | |
|--|-----------------------|-------|-----------------------|--------|
| | September 30, 2013 | 2012 | September 30, 2013 | 2012 |
| <i>(Dollars in thousands, except per share data)</i> | | | | |
| Interest income: | | | | |
| Loans receivable | \$5,492 | 7,208 | 17,023 | 22,527 |
| Securities available for sale: | | | | |
| Mortgage-backed and related | 66 | 133 | 242 | 490 |
| Other marketable | 156 | 160 | 443 | 601 |
| Cash equivalents | 12 | 25 | 80 | 71 |
| Other | 3 | 25 | 51 | 89 |
| Total interest income | 5,729 | 7,551 | 17,839 | 23,778 |
| Interest expense: | | | | |
| Deposits | 404 | 804 | 1,426 | 3,082 |
| Federal Home Loan Bank advances | 0 | 855 | 1,485 | 2,544 |
| Total interest expense | 404 | 1,659 | 2,911 | 5,626 |
| Net interest income | 5,325 | 5,892 | 14,928 | 18,152 |
| Provision for loan losses | (4,330) | 1,584 | (4,850) | 2,544 |
| Net interest income after provision for loan losses | 9,655 | 4,308 | 19,778 | 15,608 |
| Non-interest income: | | | | |
| Fees and service charges | 929 | 821 | 2,601 | 2,484 |
| Mortgage servicing fees | 267 | 245 | 772 | 713 |
| Gain on sales of loans | 433 | 940 | 1,813 | 2,469 |
| Gain on sale of branch office | 0 | 0 | 0 | 552 |
| Other | 194 | 110 | 498 | 398 |
| Total non-interest income | 1,823 | 2,116 | 5,684 | 6,616 |
| Non-interest expense: | | | | |
| Compensation and benefits | 3,009 | 2,955 | 9,188 | 9,587 |
| (Gain) loss on real estate owned | (282) | (172) | (607) | (75) |
| Occupancy | 867 | 805 | 2,543 | 2,526 |
| Deposit insurance | 172 | 353 | 680 | 928 |
| Data processing | 313 | 333 | 968 | 1,006 |
| Other | 1,207 | 1,513 | 3,878 | 4,416 |
| Total non-interest expense | 5,286 | 5,787 | 16,650 | 18,388 |

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| | | | | |
|--|---------|--------|----------|----------|
| Income before income tax expense | 6,192 | 637 | 8,812 | 3,836 |
| Income tax expense | 158 | 0 | 238 | 0 |
| Net income | 6,034 | 637 | 8,574 | 3,836 |
| Preferred stock dividends and discount | (523) | (467) | (1,546) | (1,392) |
| Net income for common shareholders | \$5,511 | 170 | 7,028 | 2,444 |
| Other comprehensive income (loss), net of tax | \$473 | (77) | (1,045) | (349) |
| Comprehensive income attributable to common shareholders | \$5,984 | 93 | 5,983 | 2,095 |
| Basic earnings per common share | \$1.38 | 0.04 | 1.76 | 0.62 |
| Diluted earnings per common share | \$1.27 | 0.04 | 1.65 | 0.61 |

See accompanying notes to consolidated financial statements.

HMN FINANCIAL, INC. AND SUBSIDIARIES**Consolidated Statement of Stockholders' Equity****For the Nine-Month Period Ended September 30, 2013**

(unaudited)

| <i>(Dollars in thousands)</i> | Preferred Stock | Common Stock | Additional Paid-in Capital | Retained Earnings | Other Comprehensive Loss | Unearned | | Total Stock- Holders' Equity |
|--|--------------------|-----------------|----------------------------------|----------------------|--------------------------------|--|-------------------|---------------------------------------|
| | | | | | | Accumulated Employee Ownership Plan Shares | Treasury Stock | |
| Balance, December 31, 2012 | \$25,336 | 91 | 51,795 | 47,004 | (49) | (2,997) | (60,346) | 60,834 |
| Net income | | | | 8,574 | | | | 8,574 |
| Other comprehensive loss | | | | | (1,045) | | | (1,045) |
| Preferred stock discount amortization | 442 | | (442) | | | | | 0 |
| Stock compensation tax benefits | | | 3 | | | | | 3 |
| Restricted stock awards forfeited | | | 208 | | | | (327) | (119) |
| Amortization of restricted stock awards | | | 101 | | | | | 101 |
| Preferred stock dividends accrued | | | | (1,090) | | | | (1,090) |
| Earned employee stock ownership plan shares | | | (27) | | | 145 | | 118 |
| Balance, September 30, 2013 | \$25,778 | 91 | 51,638 | 54,488 | (1,094) | (2,852) | (60,673) | 67,376 |

See accompanying notes to consolidated financial statements.

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

(unaudited)

| | Nine Months Ended | |
|---|-------------------|-----------|
| | September 30, | 2012 |
| | 2013 | 2012 |
| <i>(Dollars in thousands)</i> | | |
| Cash flows from operating activities: | | |
| Net income | \$8,574 | 3,836 |
| Adjustments to reconcile net income to cash provided by operating activities: | | |
| Provision for loan losses | (4,850) | 2,544 |
| Depreciation | 751 | 833 |
| Amortization of premiums, net | 67 | 79 |
| Amortization of deferred loan fees | (238) | (359) |
| Amortization of mortgage servicing rights, net | 463 | 548 |
| Capitalized mortgage servicing rights | (500) | (643) |
| Gain on sales of real estate | (607) | (75) |
| Gain on sales of loans | (1,813) | (2,469) |
| Proceeds from sale of loans held for sale | 74,298 | 91,025 |
| Disbursements on loans held for sale | (60,407) | (81,510) |
| Amortization of restricted stock awards | 101 | 183 |
| Amortization of unearned ESOP shares | 145 | 146 |
| Cancellation of vested restricted stock awards | (119) | 0 |
| Earned employee stock ownership shares priced below original cost | (27) | (59) |
| Stock option compensation | 3 | 6 |
| Decrease in accrued interest receivable | 201 | 314 |
| Decrease in accrued interest payable | (120) | (543) |
| Decrease in other assets | 830 | 572 |
| Increase (decrease) in other liabilities | 251 | (1,375) |
| Other, net | 221 | 114 |
| | 17,224 | 13,167 |
| Net cash provided by operating activities | | |
| Cash flows from investing activities: | | |
| Principal collected on securities available for sale | 4,206 | 7,963 |
| Proceeds collected on maturities of securities available for sale | 11,000 | 103,000 |
| Purchases of securities available for sale | (20,092) | (44,037) |
| Redemption of Federal Home Loan Bank Stock | 3,279 | 159 |
| Proceeds from sales of real estate and premises | 3,655 | 5,870 |
| Net decrease in loans receivable | 53,583 | 69,693 |
| Gain on sale of branch office | 0 | (552) |
| Payment on sale of branch office | 0 | (36,981) |
| Purchases of premises and equipment | (310) | (221) |

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| | | |
|--|----------|-----------|
| Net cash provided by investing activities | 55,321 | 104,894 |
| Cash flows from financing activities: | | |
| Decrease in deposits | (29,051) | (109,992) |
| Proceeds from borrowings | 12,000 | 0 |
| Repayment of borrowings | (82,000) | 0 |
| Increase in customer escrows | 498 | 491 |
| Net cash used by financing activities | (98,553) | (109,501) |
| | (26,008) | 8,560 |
| (Decrease) increase in cash and cash equivalents | | |
| Cash and cash equivalents, beginning of period | 83,660 | 67,840 |
| | \$57,652 | 76,400 |
| Cash and cash equivalents, end of period | | |
| Supplemental cash flow disclosures: | | |
| Cash paid for interest | \$3,031 | 6,169 |
| Cash paid for income taxes | 205 | 10 |
| Supplemental noncash flow disclosures: | | |
| Transfer of loans to real estate | 1,563 | 1,895 |
| Loans transferred to loans held for sale | 10,665 | 7,955 |

See accompanying notes to consolidated financial statements.

HMN FINANCIAL, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(unaudited)

September 30, 2013 and 2012

(1) HMN Financial, Inc.

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

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

(2) Basis of Preparation

The accompanying unaudited consolidated financial statements were prepared in accordance with instructions for Form 10-Q and therefore, do not include all disclosures necessary for a complete presentation of the consolidated balance sheets, consolidated statements of comprehensive income, consolidated statement of stockholders' equity and consolidated statements of cash flows in conformity with U.S. generally accepted accounting principles. However, all normal recurring adjustments which are, in the opinion of management, necessary for the fair presentation of the interim financial statements have been included. The results of operations for the nine-month period ended September 30, 2013 are not necessarily indicative of the results which may be expected for the entire year.

(3) New Accounting Standards

In January 2013, the Financial Accounting Standards Board (the FASB) issued ASU 2013-01, *Balance Sheet (Topic 210)*. The objective of this ASU is to clarify that the scope of ASU 2011-11, *Balance Sheet (Topic 210)*, applies to derivatives including bifurcated embedded derivatives, repurchase agreements and reverse repurchase agreements, and securities borrowing and securities lending transactions that are either offset in accordance with Section 210-20-45 or Section 815-10-45 or are subject to a master netting arrangement or similar agreement. This ASU is the final version of proposed ASU 2011-11, *Balance Sheet (Topic 210)*, which has been deleted. An entity is required to apply the amendments for fiscal years beginning on or after January 1, 2013, and interim periods within those annual periods.

The adoption of this ASU did not have any impact on the Company's consolidated financial statements as the Company has no outstanding rights of setoff.

In February 2013, the FASB issued ASU 2013-02, *Other Comprehensive Income (Topic 220)*. The amendments in the ASU supersede and replace the presentation requirements of reclassifications out of accumulated other comprehensive income in ASUs 2011-05 (issued in June 2011) and 2011-12 (issued in December 2011) for all public and private organizations. The amendments require an entity to provide additional information about reclassifications out of accumulated other comprehensive income. For public entities, the amendments are effective prospectively for reporting periods beginning after December 15, 2012. The adoption of this ASU did not have a material impact on the Company's consolidated financial statements.

(4) Derivative Instruments and Hedging Activities

The Company has commitments outstanding to extend credit to future borrowers that have not closed prior to the end of the quarter. The Company intends to sell these commitments, which are referred to as its "mortgage pipeline." As commitments to originate loans enter the mortgage pipeline, the Company generally enters into commitments to sell the mortgage pipeline into the secondary market on a firm commitment or best efforts basis. The commitments to originate, purchase or sell loans on a firm commitment basis are derivatives. As a result of marking to market the mortgage pipeline and the related firm commitments to sell at September 30, 2013, the Company recorded an increase in other assets of \$22,000 and an increase in other liabilities of \$22,000.

The current commitments to sell loans held for sale are derivatives that do not qualify for hedge accounting. As a result, these derivatives are marked to market and the related loans held for sale are recorded at the lower of cost or market. The Company recorded an increase in other liabilities of \$25,000 and a loss included in the gain on sales of loans of \$25,000 at ended September 30, 2013.

(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 and liabilities of the Company for which fair values are determined on a recurring basis as of September 30, 2013 and December 31, 2012.

| <i>(Dollars in thousands)</i> | Carrying value at September 30, 2013 | | | |
|-------------------------------|---|------------|---------|------------|
| | Total | Level 1 | Level 2 | Level 3 |
| Securities available for sale | \$89,687 | 0 | 89,687 | 0 |
| Mortgage loan commitments | 22 | 0 | 22 | 0 |
| Total | \$89,709 | 0 | 89,709 | 0 |

Carrying value at December 31,
2012

| <i>(Dollars in thousands)</i> | Total | Level 1 | Level 2 | Level 3 |
|-------------------------------|----------|------------|---------|------------|
| Securities available for sale | \$85,891 | 81 | 85,810 | 0 |
| Mortgage loan commitments | 27 | 0 | 27 | 0 |
| Total | \$85,918 | 81 | 85,837 | 0 |

There were no transfers between Levels 1, 2, or 3 during the three or nine month periods ended September 30, 2013.

The Company may also be required, from time to time, to measure certain other financial assets at fair value on a nonrecurring basis in accordance with generally accepted accounting principles. These adjustments to fair value usually result from the application of the lower-of-cost-or-market accounting or write-downs of individual assets. For assets measured at fair value on a nonrecurring basis in the third quarter of 2013 that were still held at September 30, 2013, the following table provides the level of valuation assumptions used to determine each adjustment and the carrying value of the related individual assets or portfolios at September 30, 2013 and December 31, 2012.

| | | | | | Carrying value at September 30, 2013 | |
|---------------------------------|----------|------------|---------|------------|---|----------------------------|
| | | | | | Three months ended | Nine months ended |
| <i>(Dollars in thousands)</i> | Total | Level 1 | Level 2 | Level 3 | September 30, 2013 | September 30, 2013 |
| | | | | | Total gains (losses) | Total gains (losses) |
| Loans held for sale | \$1,180 | 0 | 1,180 | 0 | 48 | 10 |
| Mortgage servicing rights | 1,769 | 0 | 1,769 | 0 | 0 | 0 |
| Loans ⁽¹⁾ | 21,585 | 0 | 21,585 | 0 | 614 | (4,252) |
| Real estate, net ⁽²⁾ | 8,899 | 0 | 8,899 | 0 | (14) | (327) |
| Total | \$33,433 | 0 | 33,433 | 0 | 648 | (4,569) |

| | | | | | Carrying value at December 31, 2012 | |
|---------------------------------|----------|------------|---------|------------|--|----------------------------|
| | | | | | Year ended | |
| <i>(Dollars in thousands)</i> | Total | Level 1 | Level 2 | Level 3 | December 31, 2012 | Total gains (losses) |
| Loans held for sale | \$2,584 | 0 | 2,584 | 0 | 15 | |
| Mortgage servicing rights | 1,732 | 0 | 1,732 | 0 | 0 | |
| Loans ⁽¹⁾ | 32,287 | 0 | 32,287 | 0 | (2,307) | |
| Real estate, net ⁽²⁾ | 10,595 | 0 | 10,595 | 0 | (569) | |
| Total | \$47,198 | 0 | 47,198 | 0 | (2,861) | |

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

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

(6) Fair Value of Financial Instruments

Generally accepted accounting principles require interim reporting period disclosure about the fair value of financial instruments, including assets, liabilities and off-balance sheet items for which it is practicable to estimate fair value. The fair value hierarchy level for each asset and liability, as defined in note 5, have been included in the following table for September 30, 2013. The fair value estimates are made based upon relevant market information, if available, and upon the characteristics of the financial instruments themselves. Because no market exists for a significant portion of the Company's financial instruments, fair value estimates are based upon judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments and other factors. The estimated fair value of the Company's financial instruments as of September 30, 2013 and December 31, 2012 are shown below.

| <i>(Dollars in thousands)</i> | September 30, 2013 | | | | | December 31, 2012 | | | | | |
|--|--------------------|----------------------|----------------------|---------|---------|-------------------|-----------------|----------------------|----------------------|---------|---------|
| | Carrying amount | Estimated fair value | Fair value hierarchy | | | Contract amount | Carrying amount | Estimated fair value | Fair value hierarchy | | |
| | | | Level 1 | Level 2 | Level 3 | | | | Level 1 | Level 2 | Level 3 |
| Financial assets: | | | | | | | | | | | |
| Cash and cash equivalents | \$57,652 | 57,652 | 57,652 | 0 | 0 | 83,660 | 83,660 | 83,660 | 0 | 0 | |
| Securities available for sale | 89,687 | 89,687 | 0 | 89,687 | 0 | 85,891 | 85,891 | 81 | 85,810 | 0 | |
| Loans held for sale | 1,180 | 1,180 | 0 | 1,180 | 0 | 2,584 | 2,584 | 0 | 2,584 | 0 | |
| Loans receivable, net | 393,322 | 397,827 | 0 | 397,827 | 0 | 454,045 | 459,177 | 0 | 459,177 | 0 | |
| Accrued interest receivable | 1,817 | 1,817 | 0 | 1,817 | 0 | 2,018 | 2,018 | 0 | 2,018 | 0 | |
| Financial liabilities: | | | | | | | | | | | |
| Deposits | 485,921 | 485,921 | 0 | 485,921 | 0 | 514,951 | 514,951 | 0 | 514,951 | 0 | |
| Federal Home Loan Bank advances | 0 | 0 | 0 | 0 | 0 | 70,000 | 71,623 | 0 | 71,623 | 0 | |
| Accrued interest payable | 127 | 127 | 0 | 127 | 0 | 247 | 247 | 0 | 247 | 0 | |
| Off-balance sheet financial instruments: | | | | | | | | | | | |

| | | | | | | |
|------------------------------------|-----|-------|---------|-----|-------|-------|
| Commitments to extend credit | 22 | 22 | 119,398 | 27 | 27 | 84,87 |
| Commitments to sell loans | (46 |) (46 | 2,533 | (40 |) (40 | 7,046 |

Cash and Cash Equivalents

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

Securities Available for Sale

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

Loans Held for Sale

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

Loans Receivable, net

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

Accrued Interest Receivable

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

Deposits

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

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

Federal Home Loan Bank Advances

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

Accrued Interest Payable

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

Commitments to Extend Credit

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

Commitments to Sell Loans

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

(7) Comprehensive Income (Loss)

Other comprehensive income (loss) is defined as the change in equity during a period from transactions and other events from nonowner sources. Comprehensive income (loss) is the total of net income (loss) and other comprehensive income (loss), which for the Company is comprised of unrealized gains and losses on securities available for sale. The components of other comprehensive income (loss) and the related tax effects for the quarter and nine-months ended September 30, 2013 and 2012 were as follows:

| <i>(Dollars in thousands)</i> | For the three months ended September 30, | | | | | |
|---|--|------------|------------|------------|------------|------------|
| | 2013 | | | 2012 | | |
| Securities available for sale: | Before tax | Tax effect | Net of tax | Before tax | Tax effect | Net of tax |
| Net unrealized gains (losses) arising during the period | \$473 | 0 | 473 | (77) | 0 | (77) |
| Other comprehensive income (loss) | \$473 | 0 | 473 | (77) | 0 | (77) |

| <i>(Dollars in thousands)</i> | For the nine months ended September 30, | | | | | |
|---|---|------------|------------|------------|------------|------------|
| | 2013 | | | 2012 | | |
| Securities available for sale: | Before tax | Tax effect | Net of tax | Before tax | Tax effect | Net of tax |
| Net unrealized losses arising during the period | \$(1,045) | 0 | (1,045) | (349) | 0 | (349) |
| Other comprehensive loss | \$(1,045) | 0 | (1,045) | (349) | 0 | (349) |

There is no tax effect shown in the above schedule at September 30, 2013 or 2012 since no regular income tax expense was recorded during these periods.

(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 September 30, 2013 and December 31, 2012.

| <i>(Dollars in thousands)</i> | September 30, 2013 | | | | | | | |
|------------------------------------|-------------------------|-------------|-------------------|-----------------------|-------------|-------------------|-------------|-------------------|
| | Less than twelve months | | | Twelve months or more | | | Total | |
| | # of | Fair Value | Unrealized Losses | # of | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| | | Investments | | | Investments | | Investments | |
| Other marketable securities: | | | | | | | | |
| U.S. Government agency obligations | 15 | \$68,386 | (643) | 0 | \$0 | 0 | \$68,386 | (643) |
| Corporate preferred stock | 0 | 0 | 0 | 1 | 245 | (455) | 245 | (455) |

Total temporarily impaired securities 15 \$68,386 (643) 1 \$ 245 (455) \$68,631 (1,098)

| | December 31, 2012 | | | | | | | |
|---------------------------------------|-------------------------|------------|-------------------|-----------------------|------------|-------------------|------------|-------------------|
| | Less than twelve months | | | Twelve months or more | | | Total | |
| | # of Investments | Fair Value | Unrealized Losses | # of Investments | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| <i>(Dollars in thousands)</i> | | | | | | | | |
| Other marketable securities: | | | | | | | | |
| U.S. Government agency obligations | 1 | \$4,996 | (4) | 0 | \$ 0 | 0 | \$4,996 | (4) |
| Corporate preferred stock | 0 | 0 | 0 | 1 | 245 | (455) | 245 | (455) |
| Total temporarily impaired securities | 1 | \$4,996 | (4) | 1 | \$ 245 | (455) | \$5,241 | (459) |

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

The unrealized losses reported for corporate preferred stock at September 30, 2013 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 "well capitalized" based on its most recent regulatory filing. Based on a review of the issuer, it was determined that the trust preferred security was not other-than-temporarily impaired at September 30, 2013. The Company does not intend to sell the preferred stock and has the intent and ability to hold it for a period of time sufficient to recover the temporary loss. Management believes that the Company will receive all principal and interest payments contractually due on the security and that the decrease in the market value is primarily due to a lack of liquidity in the market for trust preferred securities and the deferral of interest by the issuer. Management will continue to monitor the credit risk of the issuer and may be required to recognize other-than-temporary impairment charges on this security in future periods.

A summary of securities available for sale at September 30, 2013 and December 31, 2012 is as follows:

| <i>(Dollars in thousands)</i> | Amortized cost | Gross unrealized gains | Gross unrealized losses | Fair value |
|------------------------------------|-------------------|------------------------------|-------------------------------|---------------|
| <u>September 30, 2013:</u> | | | | |
| Mortgage-backed securities: | | | | |
| FHLMC | \$ 2,431 | 144 | 0 | 2,575 |
| FNMA | 3,194 | 204 | 0 | 3,398 |
| | 5,625 | 348 | 0 | 5,973 |
| Other marketable securities: | | | | |
| U.S. Government agency obligations | 84,042 | 3 | (643) | 83,402 |
| Common stock | 58 | 9 | 0 | 67 |
| Corporate preferred stock | 700 | 0 | (455) | 245 |
| | 84,800 | 12 | (1,098) | 83,714 |
| | \$ 90,425 | 360 | (1,098) | 89,687 |

| <i>(Dollars in thousands)</i> | Amortized cost | Gross unrealized gains | Gross unrealized losses | Fair value |
|--------------------------------------|-------------------|------------------------------|-------------------------------|---------------|
| <u>December 31, 2012:</u> | | | | |
| Mortgage-backed securities: | | | | |
| FHLMC | \$ 5,669 | 294 | 0 | 5,963 |
| FNMA | 4,076 | 301 | 0 | 4,377 |
| Collateralized mortgage obligations: | | | | |
| FNMA | 80 | 1 | 0 | 81 |
| | 9,825 | 596 | 0 | 10,421 |

Other marketable securities:

| | | | | | |
|------------------------------------|-----------|-----|------|---|--------|
| U.S. Government agency obligations | 75,059 | 170 | (4 |) | 75,225 |
| Corporate preferred stock | 700 | 0 | (455 |) | 245 |
| | 75,759 | 170 | (459 |) | 75,470 |
| | \$ 85,584 | 766 | (459 |) | 85,891 |

The following table indicates amortized cost and estimated fair value of securities available for sale at September 30, 2013 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 | Fair |
|--|-----------|--------|
| | Cost | Value |
| Due less than one year | \$ 56,147 | 55,792 |
| Due after one year through five years | 33,520 | 33,583 |
| Due after five years through ten years | 0 | 0 |
| Due after ten years | 758 | 312 |
| Total | \$ 90,425 | 89,687 |

The allocation of mortgage-backed securities 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 that it is anticipated that the security will be called, or to the maturity date if it is not anticipated to be called.

(9) Loans Receivable, Net

A summary of loans receivable at September 30, 2013 and December 31, 2012 is as follows:

| <i>(Dollars in thousands)</i> | September 30, 2013 | December 31, 2012 |
|--------------------------------|--------------------------|-------------------------|
| 1-4 family | \$ 78,581 | 97,037 |
| Commercial real estate: | | |
| Residential developments | 37,425 | 46,343 |
| Other | 170,036 | 198,564 |
| Consumer | 207,461 | 244,907 |
| | 53,414 | 53,975 |
| Commercial business: | | |
| Construction industry | 6,680 | 2,666 |
| Other | 63,703 | 77,188 |
| | 70,383 | 79,854 |
| Total loans | 409,839 | 475,773 |
| Less: | | |
| Unamortized discounts | 37 | 33 |
| Net deferred loan fees (costs) | (25) | 87 |
| Allowance for loan losses | 16,505 | 21,608 |
| Total loans receivable, net | \$ 393,322 | 454,045 |

(10) Allowance for Loan Losses and Credit Quality Information

The allowance for loan losses is summarized as follows:

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| <i>(Dollars in thousands)</i> | 1-4 Family | Commercial Real Estate | Consumer | Commercial Business | Total |
|---|---------------|---------------------------|----------|------------------------|----------|
| <u>For the three months ended September 30, 2013:</u> | | | | | |
| Balance, June 30, 2013 | \$2,059 | 14,089 | 1,431 | 2,780 | 20,359 |
| Provision for losses | (675) | (3,512) | (58) | (85) | (4,330) |
| Charge-offs | 0 | (2) | (374) | (50) | (426) |
| Recoveries | 0 | 711 | 14 | 177 | 902 |
| Balance, September 30, 2013 | \$1,384 | 11,286 | 1,013 | 2,822 | 16,505 |
| <u>For the nine months ended September 30, 2013:</u> | | | | | |
| Balance, December 31, 2012 | \$2,821 | 13,588 | 1,146 | 4,053 | 21,608 |
| Provision for losses | (1,250) | (2,646) | 256 | (1,210) | (4,850) |
| Charge-offs | (200) | (911) | (475) | (606) | (2,192) |
| Recoveries | 13 | 1,255 | 86 | 585 | 1,939 |
| Balance, September 30, 2013 | \$1,384 | 11,286 | 1,013 | 2,822 | 16,505 |
| Allocated to: | | | | | |
| Specific reserves | \$571 | 2,591 | 537 | 1,114 | 4,813 |
| General reserves | 2,250 | 10,997 | 609 | 2,939 | 16,795 |
| Balance, December 31, 2012 | \$2,821 | 13,588 | 1,146 | 4,053 | 21,608 |
| Allocated to: | | | | | |
| Specific reserves | \$309 | 5,218 | 335 | 690 | 6,552 |
| General reserves | 1,075 | 6,068 | 678 | 2,132 | 9,953 |
| Balance, September 30, 2013 | \$1,384 | 11,286 | 1,013 | 2,822 | 16,505 |
| <u>Loans receivable at December 31, 2012:</u> | | | | | |
| Individually reviewed for impairment | \$4,687 | 28,195 | 1,823 | 2,395 | 37,100 |
| Collectively reviewed for impairment | 92,350 | 216,712 | 52,152 | 77,459 | 438,673 |
| Ending balance | \$97,037 | 244,907 | 53,975 | 79,854 | 475,773 |

Loans receivable at September 30, 2013:

| | | | | | |
|--------------------------------------|----------|---------|--------|--------|---------|
| Individually reviewed for impairment | \$3,423 | 22,569 | 746 | 1,399 | 28,137 |
| Collectively reviewed for impairment | 75,158 | 184,892 | 52,668 | 68,984 | 381,702 |
| Ending balance | \$78,581 | 207,461 | 53,414 | 70,383 | 409,839 |

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| <i>(Dollars in thousands)</i> | 1-4 Family | Commercial Real Estate | Consumer | Commercial Business | Total |
|---|---------------|---------------------------|----------|------------------------|----------|
| <u>For the three months ended September 30, 2012:</u> | | | | | |
| Balance, June 30, 2012 | \$ 3,665 | 11,553 | 1,268 | 4,033 | 20,519 |
| Provision for losses | (621) | 2,246 | 4 | (45) | 1,584 |
| Charge-offs | 0 | (1,535) | (164) | (167) | (1,866) |
| Recoveries | 0 | 47 | 94 | 84 | 225 |
| Balance, September 30, 2012 | \$ 3,044 | 12,311 | 1,202 | 3,905 | 20,462 |
| <u>For the nine months ended September 30, 2012:</u> | | | | | |
| Balance, December 31, 2011 | \$ 3,718 | 13,622 | 1,159 | 5,389 | 23,888 |
| Provision for losses | (674) | 3,037 | 851 | (670) | 2,544 |
| Charge-offs | 0 | (5,719) | (921) | (1,996) | (8,636) |
| Recoveries | 0 | 1,371 | 113 | 1,182 | 2,666 |
| Balance, September 30, 2012 | \$ 3,044 | 12,311 | 1,202 | 3,905 | 20,462 |

The following table summarizes the amount of classified and unclassified loans at September 30, 2013 and December 31, 2012:

| <i>(Dollars in thousands)</i> | September 30, 2013 | | | | | Unclassified Total | Total Loans |
|-------------------------------|----------------------------------|-------------|----------|------|--------|-----------------------|----------------|
| | Classified Special Mention | Substandard | Doubtful | Loss | Total | | |
| 1-4 family | \$746 | 8,904 | 0 | 0 | 9,650 | 68,931 | 78,581 |
| Commercial real estate: | 0 | 26,094 | 0 | 0 | 26,094 | 11,331 | 37,425 |

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Residential developments

| | | | | | | | |
|----------|--------|--------|----|-----|--------|---------|---------|
| Other | 17,513 | 22,038 | 0 | 0 | 39,551 | 130,485 | 170,036 |
| Consumer | 0 | 439 | 60 | 247 | 746 | 52,668 | 53,414 |

Commercial business:

| | | | | | | | |
|-----------------------|----------|--------|----|-----|--------|---------|---------|
| Construction industry | 0 | 325 | 0 | 0 | 325 | 6,355 | 6,680 |
| Other | 574 | 8,711 | 0 | 0 | 9,285 | 54,418 | 63,703 |
| | \$18,833 | 66,511 | 60 | 247 | 85,651 | 324,188 | 409,839 |

December 31, 2012

| <i>(Dollars in thousands)</i> | Classified | | | | | Unclassified | |
|-------------------------------|--------------------|-------------|----------|------|---------|--------------|----------------|
| | Special Mention | Substandard | Doubtful | Loss | Total | Total | Total Loans |
| 1-4 family | \$1,004 | 13,915 | 33 | 0 | 14,952 | 82,085 | 97,037 |
| Commercial real estate: | | | | | | | |
| Residential developments | 744 | 36,210 | 0 | 0 | 36,954 | 9,389 | 46,343 |
| Other | 17,170 | 30,365 | 0 | 0 | 47,535 | 151,029 | 198,564 |
| Consumer | 0 | 1,543 | 123 | 157 | 1,823 | 52,152 | 53,975 |
| Commercial business: | | | | | | | |
| Construction industry | 0 | 320 | 0 | 0 | 320 | 2,346 | 2,666 |
| Other | 1,224 | 12,628 | 134 | 0 | 13,986 | 63,202 | 77,188 |
| | \$20,142 | 94,981 | 290 | 157 | 115,570 | 360,203 | 475,773 |

Classified loans represent special mention, substandard, doubtful and loss loans. Loans classified as substandard are loans that are generally inadequately protected by the current net worth and paying capacity of the obligor, or by the collateral pledged, if any. Loans classified as substandard have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. Loans classified as doubtful have the weaknesses of those classified as substandard, with additional characteristics that make collection in full on the basis of currently existing facts, conditions and values questionable, and there is a high possibility of loss. A loan classified as loss is considered uncollectible and of such little value that continuance as an asset on the balance sheet is not warranted. Loans classified as substandard or doubtful require the Bank to perform an analysis of the individual loan and charge-off any loans, or portion thereof, that are deemed uncollectible.

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The aging of past due loans at September 30, 2013 and December 31, 2012 is summarized as follows:

| <i>(Dollars in thousands)</i> | 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>September 30, 2013</i> | | | | | | | |
| 1-4 family | \$878 | 930 | 0 | 1,808 | 76,773 | 78,581 | 0 |
| Commercial real estate: | | | | | | | |
| Residential developments | 256 | 0 | 739 | 995 | 36,430 | 37,425 | 0 |
| Other | 101 | 0 | 0 | 101 | 169,935 | 170,036 | 0 |
| Consumer | 355 | 98 | 3 | 456 | 52,958 | 53,414 | 0 |
| Commercial business: | | | | | | | |
| Construction industry | 0 | 0 | 0 | 0 | 6,680 | 6,680 | 0 |
| Other | 0 | 0 | 0 | 0 | 63,703 | 63,703 | 0 |
| | \$1,590 | 1,028 | 742 | 3,360 | 406,479 | 409,839 | 0 |
| <i>December 31, 2012</i> | | | | | | | |
| 1-4 family | \$1,172 | 240 | 0 | 1,412 | 95,625 | 97,037 | 0 |
| Commercial real estate: | | | | | | | |
| Residential developments | 0 | 0 | 0 | 0 | 46,343 | 46,343 | 0 |
| Other | 49 | 0 | 289 | 338 | 198,226 | 198,564 | 0 |
| Consumer | 591 | 80 | 0 | 671 | 53,304 | 53,975 | 0 |
| Commercial business: | | | | | | | |
| Construction industry | 45 | 0 | 79 | 124 | 2,542 | 2,666 | 0 |

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| | | | | | | | |
|-------|---------|-----|-------|--------|---------|---------|-------|
| Other | 1,441 | 106 | 7,467 | 9,014 | 68,174 | 77,188 | 7,423 |
| | \$3,298 | 426 | 7,835 | 11,559 | 464,214 | 475,773 | 7,423 |

15

Impaired loans include loans that are non-performing (non-accruing) and loans that have been modified in a troubled debt restructuring (TDR). The following table summarizes impaired loans and related allowances as of September 30, 2013 and December 31, 2012:

| <i>(Dollars in thousands)</i> | September 30, 2013 | | | December 31, 2012 | | |
|---|---------------------|--------------------------|-------------------|---------------------|--------------------------|-------------------|
| | Recorded Investment | Unpaid Principal Balance | Related Allowance | Recorded Investment | Unpaid Principal Balance | Related Allowance |
| Loans with no related allowance recorded: | | | | | | |
| 1-4 family | \$1,583 | 1,583 | 0 | 1,617 | 1,617 | 0 |
| Commercial real estate: | | | | | | |
| Residential developments | 8,754 | 11,946 | 0 | 10,714 | 15,530 | 0 |
| Other | 335 | 335 | 0 | 640 | 640 | 0 |
| Consumer | 287 | 293 | 0 | 393 | 400 | 0 |
| Commercial business: | | | | | | |
| Construction industry | 96 | 171 | 0 | 102 | 1,038 | 0 |
| Other | 0 | 0 | 0 | 34 | 534 | 0 |
| Loans with an allowance recorded: | | | | | | |
| 1-4 family | 1,840 | 1,884 | 309 | 3,070 | 3,114 | 571 |
| Commercial real estate: | | | | | | |
| Residential developments | 12,109 | 14,400 | 4,943 | 14,061 | 16,545 | 1,669 |
| Other | 1,371 | 1,454 | 275 | 2,780 | 3,133 | 921 |
| Consumer | 459 | 459 | 335 | 1,430 | 1,430 | 537 |
| Commercial business: | | | | | | |
| Construction industry | 0 | 0 | 0 | 74 | 74 | 62 |
| Other | 1,303 | 2,055 | 690 | 2,185 | 2,936 | 1,053 |
| Total: | | | | | | |

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| | | | | | | |
|--------------------------|----------|--------|-------|--------|--------|-------|
| 1-4 family | 3,423 | 3,467 | 309 | 4,687 | 4,731 | 571 |
| Commercial real estate: | | | | | | |
| Residential developments | 20,863 | 26,346 | 4,943 | 24,775 | 32,075 | 1,669 |
| Other | 1,706 | 1,789 | 275 | 3,420 | 3,773 | 921 |
| Consumer | 746 | 752 | 335 | 1,823 | 1,830 | 537 |
| Commercial business: | | | | | | |
| Construction industry | 96 | 171 | 0 | 176 | 1,112 | 62 |
| Other | 1,303 | 2,055 | 690 | 2,219 | 3,470 | 1,053 |
| | \$28,137 | 34,580 | 6,552 | 37,100 | 46,991 | 4,813 |

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The following tables summarize average recorded investment and interest income recognized on impaired loans during the three and nine months ended September 30, 2013 and 2012.

| <i>(Dollars in thousands)</i> | For the three months ended | | For the nine months ended | |
|---|---|---|---|---|
| | September 30, 2013 Average Interest Recorded Income Investment | September 30, 2013 Average Interest Recorded Income Investment | September 30, 2013 Average Interest Recorded Income Investment | September 30, 2013 Average Interest Recorded Income Investment |
| Loans with no related allowance recorded: | | | | |
| 1-4 family | \$1,589 | 31 | 1,608 | 46 |
| Commercial real estate: | | | | |
| Residential developments | 9,127 | 29 | 9,338 | 43 |
| Other | 335 | 16 | 424 | 18 |
| Consumer | 309 | 5 | 315 | 8 |
| Commercial business: | | | | |
| Construction industry | 98 | 0 | 90 | 0 |
| Other | 0 | 0 | 9 | 0 |
| Loans with an allowance recorded: | | | | |
| 1-4 family | 2,272 | 6 | 2,571 | 19 |
| Commercial real estate: | | | | |
| Residential developments | 12,031 | 27 | 13,519 | 41 |
| Other | 1,856 | 228 | 2,249 | 232 |
| Consumer | 998 | 7 | 1,221 | 18 |
| Commercial business: | | | | |
| Construction industry | 0 | 0 | 36 | 0 |
| | 1,332 | 17 | 1,791 | 28 |

Other

Total:

| | | | | |
|--------------------------|----------|-----|--------|-----|
| 1-4 family | 3,861 | 37 | 4,179 | 65 |
| Commercial real estate: | | | | |
| Residential developments | 21,158 | 56 | 22,857 | 84 |
| Other | 2,191 | 244 | 2,673 | 250 |
| Consumer | 1,307 | 12 | 1,536 | 26 |
| Commercial business: | | | | |
| Construction industry | 98 | 0 | 126 | 0 |
| Other | 1,332 | 17 | 1,800 | 28 |
| | \$29,947 | 366 | 33,171 | 453 |

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| | For the three months ended | | For the nine months ended | |
|---|--|----|--|-----|
| | September 30, 2012 Average Interest Recorded Income Investment Recognized | | September 30, 2012 Average Interest Recorded Income Investment Recognized | |
| <i>(Dollars in thousands)</i> | | | | |
| Loans with no related allowance recorded: | | | | |
| 1-4 family | \$3,214 | 20 | 3,312 | 70 |
| Commercial real estate: | | | | |
| Residential developments | 11,737 | 60 | 10,752 | 370 |
| Other | 2,540 | 4 | 3,177 | 22 |
| Consumer | 355 | 3 | 390 | 6 |
| Commercial business: | | | | |
| Construction industry | 99 | 0 | 269 | 0 |
| Other | 1,620 | 2 | 1,556 | 8 |
| Loans with an allowance recorded: | | | | |
| 1-4 family | 3,491 | 13 | 3,780 | 52 |
| Commercial real estate: | | | | |
| Residential developments | 14,521 | 37 | 14,627 | 111 |
| Other | 2,577 | 2 | 4,272 | 4 |
| Consumer | 1,672 | 32 | 1,269 | 75 |
| Commercial business: | | | | |
| Construction industry | 243 | 0 | 164 | 0 |
| Other | 2,604 | 9 | 3,847 | 40 |
| Total: | 6,705 | 33 | 7,092 | 122 |

1-4 family

Commercial real estate:

| | | | | |
|--------------------------|--------|----|--------|-----|
| Residential developments | 26,258 | 97 | 25,379 | 481 |
| Other | 5,117 | 6 | 7,449 | 26 |
| Consumer | 2,027 | 35 | 1,659 | 81 |

Commercial business:

| | | | | |
|-----------------------|----------|-----|--------|-----|
| Construction industry | 342 | 0 | 433 | 0 |
| Other | 4,224 | 11 | 5,403 | 48 |
| | \$44,673 | 182 | 47,415 | 758 |

At September 30, 2013 and December 31, 2012, non-accruing loans totaled \$22.4 million and \$30.0 million, respectively, for which the related allowance for loan losses was \$6.1 million and \$3.2 million, respectively. The increase in the related allowances is due primarily to the decline in estimated values of collateral securing several non-accruing loans. All of the interest income that was recognized for non-accruing loans was recognized using the cash basis method of income recognition. Non-accruing loans for which no specific allowance has been recorded, because management determined that the value of the collateral was sufficient to repay the loan, totaled \$8.0 million and \$10.3 million at September 30, 2013 and December 31, 2012, respectively. Non-accrual loans also include certain loans that have had terms modified in a TDR.

The non-accrual loans at September 30, 2013 and December 31, 2012 are summarized as follows:

| <i>(Dollars in thousands)</i> | September 30, 2013 | December 31, 2012 |
|-------------------------------|-----------------------|----------------------|
| 1-4 family | \$ 1,626 | \$ 2,492 |
| Commercial real estate: | | |
| Residential developments | 18,950 | 23,652 |
| Other | 628 | 1,891 |
| Consumer | 442 | 300 |
| Commercial business: | | |
| Construction industry | 97 | 176 |
| Other | 614 | 1,464 |
| | \$ 22,357 | \$ 29,975 |

At September 30, 2013 and December 31, 2012 there were loans included in loans receivable, net, with terms that had been modified in a TDR totaling \$25.7 million and \$33.1 million, respectively. The \$0.5 million in loans that were modified in the third quarter of 2013, were non-performing at September 30, 2013. None of the loans that were modified in the third quarter of 2013 were classified but performing.

The following table summarizes TDRs at September 30, 2013 and December 31, 2012:

| <i>(Dollars in thousands)</i> | September 30, 2013 | | | December 31, 2012 | | |
|-------------------------------|--------------------|-------------|--------|-------------------|-------------|--------|
| | Accrual | Non-Accrual | Total | Accrual | Non-Accrual | Total |
| 1-4 Family | \$1,798 | 814 | 2,612 | 2,196 | 1,404 | 3,600 |
| Commercial real estate | 2,990 | 18,301 | 21,291 | 2,653 | 23,222 | 25,875 |
| Consumer | 304 | 257 | 561 | 1,522 | 292 | 1,814 |
| Commercial business | 689 | 561 | 1,250 | 754 | 1,012 | 1,766 |
| | \$5,781 | 19,933 | 25,714 | 7,125 | 25,930 | 33,055 |

There were no material commitments to lend additional funds to customers whose loans were restructured or classified as nonaccrual at September 30, 2013 or December 31, 2012.

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

When a loan is modified as a TDR, there may be a direct, material impact on the loans within the balance sheet, as principal balances may be partially forgiven. The financial effects of TDRs are presented in the following tables and represent the difference between the outstanding recorded balance pre-modification and post-modification, for the three month and nine month periods ended September 30, 2013 and 2012.

| <i>(Dollars in thousands)</i> | Three Months Ended | | | Nine Months Ended | | |
|-------------------------------|---------------------------|---|--|---------------------------|---|--|
| | September 30, 2013 | | | September 30, 2013 | | |
| | Number of Contracts | Pre-modification Outstanding Recorded Investment | Post-modification Outstanding Recorded Investment | Number of Contracts | Pre-modification Outstanding Recorded Investment | Post-modification Outstanding Recorded Investment |
| Troubled debt restructurings: | | | | | | |
| 1-4 family | 0 | \$ 0 | \$ 0 | 1 | \$ 193 | \$ 200 |
| Commercial real estate: | | | | | | |
| Other | 1 | 679 | 254 | 3 | 754 | 329 |
| Consumer | 12 | 131 | 144 | 17 | 249 | 263 |
| Commercial business: | | | | | | |
| Construction industry | 0 | 0 | 0 | 1 | 41 | 41 |
| Other | 4 | 194 | 218 | 5 | 193 | 218 |
| Total | 17 | \$ 1,004 | \$ 616 | 27 | \$ 1,430 | \$ 1,051 |

| <i>(Dollars in thousands)</i> | Three Months Ended | | | Nine Months Ended | | |
|-------------------------------|---------------------|--|---|---------------------|--|---|
| | September 30, 2012 | | | September 30, 2012 | | |
| | Number of Contracts | Pre-modification Outstanding Recorded Investment | Post-modification Outstanding Recorded Investment | Number of Contracts | Pre-modification Outstanding Recorded Investment | Post-modification Outstanding Recorded Investment |
| Troubled debt restructurings: | | | | | | |
| 1-4 family | 4 | \$ 452 | \$ 439 | 31 | \$ 3,666 | \$ 3,643 |
| Commercial real estate: | | | | | | |
| Residential developments | 3 | 2,565 | 1,702 | 10 | 14,044 | 11,524 |
| Other | 0 | 0 | 0 | 6 | 2,814 | 2,587 |
| Consumer | 4 | 183 | 205 | 15 | 1,413 | 1,435 |
| Commercial business: | | | | | | |
| Construction industry | 0 | 0 | 0 | 1 | 80 | 80 |
| Other | 2 | 211 | 211 | 4 | 471 | 471 |
| Total | 13 | \$ 3,411 | \$ 2,557 | 67 | \$ 22,488 | \$ 19,740 |

None of the loans that were restructured within the 12 months preceding September 30, 2013 defaulted during the three and nine months ended September 30, 2013. Loans that were restructured within the 12 months preceding September 30, 2012 that defaulted during the three and nine month periods ended September 30, 2012 are presented in the following table:

| <i>(Dollars in thousands)</i> | Three Months Ended | Nine Months Ended |
|---|---|---|
| | September 30, 2012 | September 30, 2012 |
| | Number of Contracts Outstanding Recorded Investment | Number of Contracts Outstanding Recorded Investment |
| Troubled debt restructurings that subsequently defaulted: | | |

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| | | | | |
|-------------------------|---|--------|----|----------|
| 1-4 family | 0 | \$ 0 | 2 | \$ 940 |
| Commercial real estate: | | | | |
| Other | 0 | 0 | 2 | 159 |
| Consumer | 1 | 71 | 1 | 71 |
| Commercial business: | | | | |
| Other | 2 | 227 | 5 | 3,004 |
| Total | 3 | \$ 298 | 10 | \$ 4,174 |

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

Loans that were non-accrual prior to modification remain on non-accrual status for at least six months following modification. Non-accrual TDR loans that have performed according to the modified terms for six months may be returned to accrual status. Loans that were accruing prior to modification remain on accrual status after the modification as long as the loan continues to perform under the new terms.

TDRs are reviewed for impairment following the same methodology as other impaired loans. For loans that are collateral dependent, the value of the collateral is reviewed and additional reserves may be added as needed. Loans that are not collateral dependent may have additional reserves established if deemed necessary. The allowance for loan losses on TDRs was \$5.8 million, or 34.9%, of the total \$16.5 million in loan loss reserves at September 30, 2013 and \$3.7 million, or 17.2%, of the total \$21.6 million in loan loss reserves at December 31, 2012.

(11) Investment in Mortgage Servicing Rights

A summary of mortgage servicing rights activity is as follows:

| <i>(Dollars in thousands)</i> | Nine Months ended | Twelve Months ended | Nine Months ended |
|---|-------------------------|---------------------------|-------------------------|
| | September 30, 2013 | December 31, 2012 | September 30, 2012 |
| Mortgage servicing rights: | | | |
| Balance, beginning of period | \$ 1,732 | 1,485 | 1,485 |
| Originations | 500 | 979 | 643 |
| Amortization | (463) | (732) | (548) |
| Balance, end of period | \$ 1,769 | 1,732 | 1,580 |
| Fair value of mortgage servicing rights | \$ 2,919 | 2,126 | 2,047 |

All of the loans being serviced are single family loans serviced for the Federal National Mortgage Association (FNMA) under the mortgage-backed security program or the individual loan sale program. The following is a summary of the risk characteristics of the loans being serviced at September 30, 2013.

| <i>(Dollars in thousands)</i> | Loan Principal Balance | Weighted Average Interest Rate | Weighted Average Remaining Term (months) | Number of Loans |
|----------------------------------|------------------------------|---|--|-----------------------|
| Original term 30 year fixed rate | \$205,321 | 4.37 % | 303 | 1,756 |
| Original term 15 year fixed rate | 122,007 | 3.44 % | 146 | 1,381 |
| Adjustable rate | 206 | 3.85 % | 323 | 5 |

The gross carrying amount of mortgage servicing rights and the associated accumulated amortization at September 30, 2013 and 2012 is presented in the table below.

September 30, 2013

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| <i>(Dollars in thousands)</i> | Gross | | | Unamortized |
|-------------------------------|----------|--------------|-----------|-------------|
| | Carrying | Accumulated | Mortgage | |
| | | Amortization | Servicing | |
| | Amount | |) | Rights |
| Mortgage servicing rights | \$2,585 | (816 |) | 1,769 |
| Total | \$2,585 | (816 |) | 1,769 |

| <i>(Dollars in thousands)</i> | September 30, 2012 | | | |
|-------------------------------|--------------------|-------------|----------|-------------|
| | Gross | | | Unamortized |
| | Carrying | Accumulated | Mortgage | |
| Amortization | | Servicing | | |
| | Amount | |) | Rights |
| Mortgage servicing rights | \$2,244 | (664 |) | 1,580 |
| Total | \$2,244 | (664 |) | 1,580 |

Amortization expense for mortgage servicing rights was \$463,000 and \$548,000 respectively, for the nine-month periods ended September 30, 2013 and 2012. The following table indicates the estimated future amortization expense for mortgage servicing rights:

| <i>(Dollars in thousands)</i> | Mortgage |
|-------------------------------|------------------|
| | Servicing Rights |
| Year ended December 31, | |
| 2013 | \$ 106 |
| 2014 | 416 |
| 2015 | 395 |
| 2016 | 346 |
| 2017 | 254 |
| 2018 and beyond | 252 |
| Total | \$ 1,769 |

Projections of amortization are based on existing asset balances and the existing interest rate environment as of September 30, 2013. The Company's actual experiences may be significantly different depending upon changes in mortgage interest rates and other market conditions.

(12) Earnings per Common Share

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

| | Three Months Ended September 30, 2013 | | Nine Months Ended September 30, 2012 | |
|--|--|-------|---|-------|
| <i>(Dollars in thousands, except per share data)</i> | | | | |
| Weighted average number of common shares outstanding used in basic earnings per common share calculation | 4,000 | 3,957 | 3,996 | 3,936 |
| Net dilutive effect of: | | | | |
| Options | 310 | 0 | 221 | 0 |
| Restricted stock awards | 31 | 79 | 40 | 91 |
| Weighted average number of shares outstanding adjusted for effect of dilutive securities | 4,341 | 4,036 | 4,257 | 4,027 |
| Income available to common shareholders | \$5,511 | 170 | 7,028 | 2,444 |
| Basic earnings per common share | \$1.38 | 0.04 | 1.76 | 0.62 |
| Diluted earnings per common share | \$1.27 | 0.04 | 1.65 | 0.61 |

(13) Regulatory Capital and Regulatory Oversight

On July 21, 2011, the Office of Thrift Supervision (the OTS) was integrated into the Office of the Comptroller of the Currency (the OCC), which became the Bank's primary banking regulator, and the primary banking regulator for the Company became the Federal Reserve Board (the FRB).

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

The Bank entered into a written Supervisory Agreement with 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 its primary regulator on December 9, 2009. In accordance with the agreement, the Bank submitted a two year business plan in May of 2011 that the OCC accepted with the expectation that the Bank would be in adherence with the OCC's Notification of Establishment of Higher Minimum Capital Ratios, dated August 8, 2011, or IMCR, which required the Bank to establish and maintain a minimum core capital ratio of 8.5% by December 31, 2011. The IMCR is discussed more fully below. As required by the Supervisory Agreement, the Bank submitted updated two year business and problem asset reduction plans in January of 2012 and 2013. The Bank must operate within the parameters of the current business and problem asset reduction plans and is required to monitor and submit periodic reports on its compliance with the plans. The Bank has also revised its loan modification policies and its program for identifying, monitoring and controlling risk associated with concentrations of credit, and improved the documentation relating to the allowance for loan and lease losses as required by the Supervisory Agreement. In addition, without the consent of the OCC, the Bank may not declare or pay any cash dividends, increase its total assets during any quarter in excess of the amount of the net interest credited on deposit liabilities during the prior quarter, enter into any new contractual arrangement or renew or extend any existing arrangement related to compensation or benefits with any directors or officers, make any golden parachute payments, or enter into any significant contracts with a third party service provider. The Bank believes it was in compliance with all requirements of the Supervisory Agreement at September 30, 2013.

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 its primary regulator on December 9, 2009. As required by the Supervisory Agreement, the Company submitted updated two year consolidated capital plans in January of 2012 and 2013. The Company must operate within the parameters of the current capital plan and is required to monitor and submit periodic reports on its compliance with the plan. In addition, without the consent of the FRB, 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 director or officer, or make any golden parachute payments. The Company believes it was in compliance with all requirements of its Supervisory Agreement at September 30, 2013.

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

On September 30, 2013, the Bank's tangible assets were \$562.2 million, its adjusted total assets were \$563.3 million and its risk-weighted assets were \$395.7 million. The following table presents the Bank's capital amounts and ratios at September 30, 2013 for actual capital, required capital and excess capital, including ratios in order to qualify as being well capitalized under the Prompt Corrective Actions regulations.

| | Actual | | Required to be Adequately Capitalized | | Excess Capital | | To Be Well Capitalized Under Prompt Corrective Actions Provisions ⁽¹⁾ | |
|---|----------|----------------------------------|---------------------------------------|----------------------------------|----------------|----------------------------------|--|----------------------------------|
| | Amount | Percent of Assets ⁽²⁾ | Amount | Percent of Assets ⁽²⁾ | Amount | Percent of Assets ⁽²⁾ | Amount | Percent of Assets ⁽²⁾ |
| <i>(Dollars in thousands)</i> | | | | | | | | |
| Bank stockholder's equity | \$70,511 | | | | | | | |
| Plus: | | | | | | | | |
| Net unrealized losses on certain securities available for sale and cash flow hedges | 1,094 | | | | | | | |
| | 71,605 | | | | | | | |
| Tier I or core capital | | | | | | | | |
| Tier I capital to adjusted total assets | | 12.71 % | \$22,534 | 4.00 % | \$49,071 | 8.71 % | \$28,167 | 5.00 % |
| Tier I capital to risk-weighted assets | | 18.10 % | \$15,828 | 4.00 % | \$55,777 | 14.10 % | \$23,742 | 6.00 % |
| Plus: | | | | | | | | |
| Allowable allowance for loan losses | 5,089 | | | | | | | |
| Risk-based capital | \$76,694 | | \$31,656 | | \$45,038 | | \$39,570 | |
| | | 19.38 % | | 8.00 % | | 11.38 % | | 10.00 % |

Risk-based capital to
risk-weighted assets

- (1) Under recently issued final rules, revised requirements will be phased in commencing January 1, 2015, as described below.
 - (2) Based upon the Bank's adjusted total assets for the purpose of the tangible and core capital ratios and risk-weighted assets for the purpose of the risk-based capital ratio.
-

The OCC established an IMCR for the Bank. An IMCR requires a bank to establish and maintain levels of capital greater than those generally required for a bank to be classified as "well-capitalized." Effective December 31, 2011, the Bank was required to establish, and subsequently maintain, core capital at least equal to 8.50% of adjusted total assets, which was in excess of the Bank's 7.14% core capital to adjusted total assets ratio at December 31, 2011. In February 2012, the Bank received a Notice of Failure to Maintain Minimum Capital Ratios from the OCC arising out of its failure to establish and maintain its IMCR of 8.50% core capital to adjusted total assets at December 31, 2011. In April 2012, the Bank submitted to the OCC a written capital plan of how it would maintain its IMCR and a contingency plan in the event the IMCR was not maintained through the Bank's primary plan. As a result of a decrease in assets and improved financial results, the Bank's core capital to adjusted total assets ratio improved to 12.71% at September 30, 2013, which equates to core capital being \$23.7 million in excess of the IMCR capital requirement at September 30, 2013.

Management believes that, as of September 30, 2013, the Bank's capital ratios were in excess of those quantitative capital ratio standards set forth under the current prompt corrective action regulations described above. However, there can be no assurance that the Bank will continue to maintain such status in the future, under the current rules or new rules described below. The OCC has extensive discretion in its supervisory and enforcement activities, and can adjust the requirement to be "well-capitalized" in the future.

In order to improve its capital ratios and maintain compliance with its IMCR, the Bank is, among other things, working to improve its financial results, reduce non-performing assets, and decrease the asset size of the Bank. In March 2012, the Bank sold substantially all of the assets and liabilities associated with its Toledo, Iowa branch, and in March 2013 the Bank's 5th Street branch office in Rochester, Minnesota was closed to further reduce costs. In light of its continued focus on complying with the IMCR, the Bank may also determine that it is necessary or prudent to dispose of other non-strategic assets. These actions have resulted, and may result in changes in the Bank's assets, liabilities and earnings, some of which may be material, during the period in which the action is taken or is consummated or over a longer period of time. Further, the Company may determine it prudent, or be required by supervising banking regulators, to issue capital of which there can be no assurance that, if issued, it would be on terms favorable to the Company. If the Company issues additional shares of common stock or other equity securities, it could dilute the ownership interests of existing stockholders and, given our current common stock trading price, raising additional capital could dilute the per share book value of the Company's common stock could dilute the Company's earnings per share and could result in a change of control of the Company and the Bank.

The capital requirements of the Company and the Bank will be affected in the future by regulatory changes approved in the final rules issued in July 2013 by the FRB and the OCC to establish an integrated regulatory capital framework for implementing the Basel III reforms of the Basel Committee on Banking Supervision for the Bank of International Settlements. The new requirements, which will be effective beginning on January 1, 2015, will, among other things, apply a strengthened set of capital requirements to both the Bank and the Company, including new requirements relating to common equity as a component of core capital and as a "capital conservation buffer" against risk, and a higher minimum core capital requirement, and will revise the rules for calculating risk-weighted assets for purposes of such requirements. The final rules make corresponding revisions to the prompt corrective action framework. Under the final rules, certain changes including the new capital ratio and buffer requirements will be phased in incrementally, with full implementation scheduled for January 1, 2019.

(14) Preferred Stock

The Company's certificate of incorporation authorizes the issuance of up to 500,000 shares of preferred stock, and on December 23, 2008, the Company completed the sale of 26,000 shares of Fixed Rate Cumulative Perpetual Preferred Stock, Series A (the Preferred Stock) to the United States Treasury. The Preferred Stock has a liquidation value of \$1,000 per share and a related warrant was also issued to purchase 833,333 shares of HMN common stock at an exercise price of \$4.68 per share. The transaction was part of the United States Treasury's Capital Purchase Program under the Emergency Economic Stabilization Act of 2008. Under the terms of the sale, the preferred shares are entitled to a quarterly cumulative compounding dividend at a stated rate of 5% per annum for each of the first five years of the investment, increasing to 9% thereafter, unless HMN redeems the shares. The Company made all required dividend payments to the Treasury on the outstanding Preferred Stock in 2009 and 2010 but has deferred the last eleven quarterly dividend payments, beginning with the February 15, 2011 dividend payment. The deferred dividend payments of \$3.8 million have been accrued for payment in the future and are being reported for the deferral period as a preferred dividend requirement that is deducted from income for financial statement purposes to arrive at the net income available to common shareholders. Under the terms of the certificate of designations for the Preferred Stock, dividend payments may be deferred but the dividend is cumulative and compounds quarterly while unpaid. In addition, since the Company failed to pay dividends for six quarters, the Treasury had the right to appoint two representatives to the Company's board of directors. The Treasury did not exercise this right while it held the Preferred Stock.

On February 8, 2013, the Treasury sold the Preferred Stock to unaffiliated third party investors in a private transaction for \$18.8 million. The Company received no proceeds from the sale and it had no effect on the terms of the outstanding Preferred Stock, including the Company's obligation to satisfy accrued and unpaid dividends prior to the payment of any dividend or other distribution to holders of junior stock, including the Company's common stock, and an increase in the dividend rate from 5% to 9%, commencing on February 15, 2014. Further, the sale of the Preferred Stock had no effect on the Company's capital, financial condition or results of operations. Because of the sale, the Company generally is no longer subject to the various executive compensation and corporate governance requirements to which participants in Treasury's Capital Purchase Program were subject while Treasury held the Preferred Stock. In addition, the Company has been advised that the current holders of substantially all of the Preferred Stock have entered into agreements with the FRB pursuant to which they have each agreed not to take actions, without the consent of the FRB, which might be construed as exercising or attempting to exercise a controlling influence over the management or policies of the Company or the Bank, including exercise of any right to elect any representatives to the Company's board of directors.

Under the terms of the Company's and Bank's Supervisory Agreements with their federal banking regulators as described in Note 13, neither the Company nor the Bank may declare or pay any cash dividends, or purchase or redeem any capital stock, without prior notice to, and consent of, these regulators. Subject to the foregoing, the Preferred Stock may be redeemed in whole or in part, at par plus accrued and unpaid dividends. The Preferred Stock is non-voting (except as described above in respect of the election of up to two directors when preferred stock dividends remain unpaid), other than certain class voting rights.

The sale of Preferred Stock did not include the sale of a warrant to purchase 833,333 shares of the Company's common stock at an exercise price of \$4.68, which Treasury continues to hold and may sell in its discretion at any time, subject to applicable securities laws and the Company's right to repurchase the warrant at fair market value under the terms of the Company's agreements with Treasury. The warrant may be exercised at any time over its ten-year term and Treasury has agreed not to exercise any voting rights received by acquiring common stock on the exercise of the warrant. The discount on the common stock warrant is being amortized over five years. Both the Preferred Stock and the discount qualify as Tier I capital.

(15) Commitments and Contingencies

The Bank issued standby letters of credit which guarantee the performance of customers to third parties. The standby letters of credit issued and available at September 30, 2013 were approximately \$1.4 million, expire over the next year, and are collateralized primarily with commercial business assets. Since the conditions under which the Bank is required to fund the standby letters of credit may not materialize, the cash requirements are expected to be less than the total outstanding commitments.

(16) Business Segments

The Bank has been identified as a reportable operating segment in accordance with the provisions of ASC 280. SFC and HMN, the holding company, 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.

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

| <i>(Dollars in thousands)</i> | Home Federal Savings Bank | Other | Eliminations | Consolidated Total |
|-------------------------------|------------------------------------|-------|--------------|-----------------------|
|-------------------------------|------------------------------------|-------|--------------|-----------------------|

**At or for the nine months ended September 30,
2013:**

| | | | | |
|--|----------|--------|---------|-----------|
| Interest income - external customers | \$17,839 | 0 | 0 | 17,839 |
| Non-interest income - external customers | 5,684 | 0 | 0 | 5,684 |
| Intersegment interest income | 0 | 1 | (1 |) 0 |
| Intersegment non-interest income | 137 | 9,390 | (9,527 |) 0 |
| Interest expense | 2,912 | 0 | (1 |) 2,911 |
| Non-interest expense | 16,205 | 582 | (137 |) 16,650 |
| Income tax expense | 0 | 238 | 0 | 238 |
| Net income | 9,393 | 8,571 | (9,390 |) 8,574 |
| Total assets | 562,541 | 71,731 | (71,707 |) 562,565 |

**At or for the nine months ended September 30,
2012:**

| | | | | |
|--|----------|--------|---------|-----------|
| Interest income - external customers | \$23,778 | 0 | 0 | 23,778 |
| Non-interest income - external customers | 6,616 | 0 | 0 | 6,616 |
| Intersegment interest income | 0 | 2 | (2 |) 0 |
| Intersegment non-interest income | 139 | 4,413 | (4,552 |) 0 |
| Interest expense | 5,628 | 0 | (2 |) 5,626 |
| Non-interest expense | 17,942 | 585 | (139 |) 18,388 |
| Net income | 4,419 | 3,830 | (4,413 |) 3,836 |
| Total assets | 643,624 | 62,721 | (62,622 |) 643,723 |

At or for the quarter ended September 30, 2013:

| | | | | |
|--|---------|--------|---------|-----------|
| Interest income - external customers | \$5,729 | 0 | 0 | 5,729 |
| Non-interest income - external customers | 1,823 | 0 | 0 | 1,823 |
| Intersegment interest income | 0 | 0 | 0 | 0 |
| Intersegment non-interest income | 45 | 6,381 | (6,426 |) 0 |
| Interest expense | 404 | 0 | 0 | 404 |
| Non-interest expense | 5,141 | 190 | (45 |) 5,286 |
| Income tax expense | 0 | 158 | 0 | 158 |
| Net income | 6,382 | 6,033 | (6,381 |) 6,034 |
| Total assets | 562,541 | 71,731 | (71,707 |) 562,565 |

At or for the quarter ended September 30, 2012:

| | | | | |
|--|---------|--------|----------|---------|
| Interest income - external customers | \$7,551 | 0 | 0 | 7,551 |
| Non-interest income - external customers | 2,116 | 0 | 0 | 2,116 |
| Intersegment non-interest income | 46 | 831 | (877) | 0 |
| Interest expense | 1,659 | 0 | 0 | 1,659 |
| Non-interest expense | 5,637 | 196 | (46) | 5,787 |
| Net income | 833 | 635 | (831) | 637 |
| Total assets | 643,624 | 62,721 | (62,622) | 643,723 |

Item 2:

HMN FINANCIAL, INC.

MANAGEMENT'S DISCUSSION AND ANALYSIS

OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Forward-looking Information

This quarterly report and other reports filed by the Company with the Securities and Exchange Commission may contain forward-looking statements within the meaning of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These statements are often identified by such forward-looking terminology as “expect,” “intend,” “look,” “believe,” “anticipate,” “estimate,” “project,” “seek,” “may,” “will,” “would,” “could,” “should,” “trend,” “ta similar statements or variations of such terms. Examples of forward-looking statements include, but are not limited to, statements relating to increasing our core deposit relationships, reducing non-performing assets, reducing expense and generating improved financial results; the adequacy and amount of available liquidity and capital resources to the Bank; the Company’s liquidity and capital requirements; our expectations for core capital and our strategies and potential strategies for improvement thereof; changes in the size of the Bank’s loan portfolio; the recovery of the valuation allowance on deferred tax assets; the amount and mix of the Bank’s non-performing assets and the appropriateness of the allowance therefor; future losses on non-performing assets; the amount of interest-earning assets; the amount and mix of brokered and other deposits (including the Company’s ability to renew brokered deposits); the availability and use of alternate funding sources, including Federal Home Loan Bank advances; the payment of dividends; the future outlook for the Company; the amount of deposits that will be withdrawn from checking and money market accounts and how the withdrawn deposits will be replaced; the projected changes in net interest income based on rate shocks; the range that interest rates may fluctuate over the next twelve months; the net market risk of interest rate shocks; the future outlook for the issuer trust preferred securities held by the Bank; and the Bank’s compliance with regulatory standards generally (including the Bank’s status as “well-capitalized”), supervisory agreements, individual minimum capital requirements or other supervisory directives or requirements to which the Company or the Bank are or may become expressly subject, specifically, and possible responses of the OCC and FRB and the Bank and the Company to any failure to comply with any such regulatory standard, agreement or requirement.

A number of factors could cause actual results to differ materially from the Company’s assumptions and expectations. Important factors that could cause our actual results and financial condition to differ materially from those indicated in the forward-looking statements include, but are not limited to: the adequacy and marketability of real estate and other collateral securing loans to borrowers; federal and state regulation and enforcement, including restrictions set forth in the supervisory agreements between each of the Company and Bank and the FRB and OCC, respectively; possible legislative and regulatory changes, including changes in the degree and manner of regulatory supervision; the ability of the Company and the Bank to establish and adhere to plans and policies relating to, among other things, capital, business, non-performing assets, loan modifications, documentation of loan loss allowance and concentrations of credit that are satisfactory to the OCC and FRB, as applicable, in accordance with the terms of the supervisory agreements and to otherwise manage the operations of the Company and the Bank to ensure compliance with other requirements set forth in the supervisory agreements; the ability of the Company and the Bank to obtain required consents from the OCC and FRB, as applicable, under the supervisory agreements or other directives; the ability of

the Bank to comply with its individual minimum capital requirement and other applicable regulatory capital requirements; enforcement activity of the OCC and FRB in the event of our non-compliance with any applicable regulatory standard, agreement or requirement; adverse economic, business and competitive developments such as shrinking interest margins, reduced collateral values, cash inflows and deposit outflows, changes in credit or other risks posed by the Company's loan and investment portfolios, relative costs associated with alternate funding sources, technological, computer-related or operational difficulties, results of litigation, and reduced demand for financial services and loan products; changes in accounting policies and guidelines, or monetary and fiscal policies of the federal government or tax laws; international economic developments; the Company's access to and adverse changes in securities markets and the investment expectations of holders of our capital stock; the market for credit related assets; or other significant uncertainties. Additional factors that may cause actual results to differ from the Company's assumptions and expectations also include those set forth in the Company's most recent filings on Forms 10-K and 10-Q 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, 2012 and Part II, Item 1A of its Quarterly Reports on Form 10-Q.

All statements in this quarterly report on Form 10-Q, including forward-looking statements, speak only as of the date hereof, and we undertake no duty to update any of the forward-looking statements after the date 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, FHLB advances, and FRB borrowings. The difference between the average rate of interest earned on assets and the average rate paid on liabilities is the "interest rate spread." Net interest income is produced when interest-earning assets equal or exceed interest-bearing liabilities and there is a positive interest rate spread. Net interest income and net interest rate spread are affected by changes in interest rates, the volume and mix of interest-earning assets and interest-bearing liabilities, and the level of non-performing assets. The Company's net income is also affected by the generation of non-interest income, which consists primarily of gains or losses from the sale of securities, gains from the sale of loans, fees for servicing mortgage loans, and the generation of fees and service charges on deposit accounts. The Bank incurs expenses in addition to interest expense in the form of salaries and benefits, occupancy expenses, provisions for loan losses, and amortization of mortgage servicing assets. The earnings of financial institutions, such as the Bank, are also significantly affected by prevailing economic and competitive conditions, particularly changes in interest rates, government monetary and fiscal policies, and regulations of various regulatory authorities. Lending activities are influenced by the demand for and supply of business credit, single family and commercial properties, competition among lenders, the level of interest rates and the availability of funds. Deposit flows and costs of deposits are influenced by prevailing market rates of interest on competing investments, account maturities and the levels of personal income and savings.

Between 2008 and 2011, the Company's commercial business and commercial real estate loan portfolios required significant 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 was primarily the result of reduced demand for real estate, particularly as it related 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 reduced the demand for single family homes and the values of existing properties and developments where the Company's commercial loan portfolio had concentrations. Consequently, our level of non-performing assets and the related provision for loan losses increased significantly through 2011, relative to periods before 2008. The increased levels of non-performing assets, related provisions for loan losses, loan charge-offs, expenses associated with real estate owned, and the allowances against deferred taxes arising from adverse results of operations, were the primary reasons for the net losses incurred by the Company in each of the years 2008 through 2011. In 2012 and to date in 2013, commercial real estate values have stabilized and fewer charge-offs have been recorded than in the corresponding periods in the previous four years.

Between December 31, 2008 and December 31, 2012, the total assets of the Company decreased \$492 million and in the first nine months of 2013 total assets declined an additional \$91 million. The decrease in assets was primarily in the commercial loan portfolio, which occurred because of loan prepayments or non-renewals as a result of the

Company's focus on improving credit quality, reducing loan concentrations, managing net interest margin and improving capital ratios. The proceeds received from loan payments were primarily used to reduce the outstanding brokered deposits and FHLB advances and these funding sources decreased \$428 million between December 31, 2008 and September 30, 2013. It is anticipated that the decreases in assets will be less in future periods as there were no FHLB advances and only \$7.6 million in outstanding brokered deposits at September 30, 2013.

Critical Accounting Estimates

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

Allowance for Loan Losses and Related Provision

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

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

Income Taxes

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

and interpretations used in determining the current and deferred income tax liabilities.

The Company maintains significant net deferred tax assets for deductible temporary differences, the largest of which relates to the allowance for loan and real estate losses and net operating loss carry forwards. For income tax purposes, only net charge-offs are deductible, not the entire provision for loan losses. Under generally accepted accounting principles, a valuation allowance is required to be recognized if it is "more likely than not" that the deferred tax asset will not be realized. The determination of whether the deferred tax assets are realizable 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 realization of deferred tax assets. Positive evidence includes current financial performance, 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 and the general business and economic environment. In the second quarter of 2010, the Company recorded a valuation allowance against the entire deferred tax asset balance and the Company continued to maintain a valuation reserve against the entire deferred tax asset balance at September 30, 2013. This determination was based primarily upon the existence of a cumulative loss position for the three-year period ended September 30, 2013 that is primarily attributable to significant provisions for loan losses incurred during certain periods within this three year period. 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. Based on the recent improvements in the financial performance of the Company, it is anticipated that the Company will be in a three year cumulative gain position at December 31, 2013 and would be eligible to eliminate a significant portion of the \$15.9 million valuation reserve that existed at September 30, 2013 against the deferred tax asset. Any reversal of the deferred tax asset valuation reserve would result in an increase in the book value of the Company's common stock and a corresponding credit provision to income tax expense. The timing and amount of any adjustment to the deferred tax asset valuation reserve will be dependent on the Company obtaining a three year cumulative gain position and an evaluation of both the positive and negative evidence relating to the ultimate realizability of the deferred tax asset as noted above.

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

RESULTS OF OPERATIONS FOR THIRD QUARTER ENDED SEPTEMBER 30, 2013 COMPARED TO THIRD QUARTER ENDED SEPTEMBER 30, 2012

Net Income

Net income was \$6.0 million for the third quarter of 2013, an improvement of \$5.4 million compared to net income of \$0.6 million for the third quarter of 2012. Net income available to common shareholders was \$5.5 million for the third quarter of 2013, an improvement of \$5.3 million from the net income available to common shareholders of \$0.2 million for the third quarter of 2012. Diluted earnings per common share for the third quarter of 2013 was \$1.27, an increase of \$1.23 from the diluted earnings per common share of \$0.04 for the third quarter of 2012. The improvement in net income for the third quarter of 2013 is due to a \$5.9 million decrease in the provision for loan losses between the periods primarily because of improving values of the underlying collateral supporting commercial real estate loans and a \$0.5 million decrease in non-interest expense. The decrease in non-interest expense was primarily due to decreased legal expenses relating to real estate owned and loan collection efforts and lower mortgage servicing rights amortization expense. These improvements to net income were partially offset by a \$0.3 million decrease in non-interest income due primarily to a decrease in the gain on sales of loans and a \$0.6 million decrease in net interest income due primarily to a decrease in interest earning assets between the periods.

Net income was \$8.6 million for the nine-month period ended September 30, 2013, an increase of \$4.8 million, or 123.5%, compared to the net income of \$3.8 million for the nine-month period ended September 30, 2012. The net income available to common shareholders was \$7.0 million for the nine-month period ended September 30, 2013, an increase of \$4.6 million, or 187.6%, compared to the net income available to common shareholders of \$2.4 million for the same period of 2012. Diluted earnings per common share for the first nine months of 2013 was \$1.65, an increase of \$1.04 per share compared to the diluted earnings per common share of \$0.61 for the same period in 2012. The improvement in net income for the first nine months of 2013 was due primarily to a \$7.4 million decrease in the provision for loan losses between the periods primarily because of improving values of the underlying collateral supporting commercial real estate loans and a \$1.7 million decrease in non-interest expenses due primarily to an increase in the gains recognized on the sale of real estate owned and a decrease in expenses related to other real estate owned. These improvements to net income were partially offset by a \$3.2 million decrease in net interest income due primarily to a decrease in interest earning assets between the periods, a \$0.9 million decrease in non-interest income due primarily to a decrease in the gain on sales of loans, a decrease in the gain related to the sale of the Bank's Toledo, Iowa branch in the first quarter of 2012, and a \$0.2 million increase in income tax expense between the periods.

Net Interest Income

Net interest income was \$5.3 million for the third quarter of 2013, a decrease of \$0.6 million, or 9.6%, compared to \$5.9 million for the third quarter of 2012. Interest income was \$5.7 million for the third quarter of 2013, a decrease of \$1.9 million, or 24.1%, from \$7.6 million for the same period in 2012. Interest income decreased between the periods primarily because of a \$99 million decrease in the average interest-earning assets and also because of a decrease in the average yields on 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 loan prepayments or non-renewals as a result of the Company's focus on improving credit quality, decreasing loan concentrations, managing net interest margin and improving capital ratios. The average yield earned on interest-earning assets was 4.41% for the third quarter of 2013, a decrease of 48 basis points from the 4.89% average yield for the third quarter of 2012. The decrease in average yield was due to the continued low short-term interest rate environment that existed during the third quarter of 2013. The increase in domestic long-term mortgage rates that began during the second quarter of 2013 did not materially impact the average yield earned on interest-earning assets during the third quarter of 2013 since most of the mortgage loans originated by the Bank are sold into the secondary market and not placed in the loan portfolio.

Interest expense was \$0.4 million for the third quarter of 2013, a decrease of \$1.3 million, or 75.6%, compared to \$1.7 million for the third quarter of 2012. Interest expense decreased primarily because of the \$108 million decrease in the average interest-bearing liabilities between the periods, largely as the result of a decrease in the outstanding borrowings and brokered certificates of deposit between the periods. The decrease in borrowings and brokered certificates of deposit between the periods was the result of using the proceeds from loan principal payments to fund maturing borrowings and brokered certificates of deposit. Interest expense also decreased because of the lower interest rates paid on money market accounts and certificates of deposit due to the low short-term interest rate environment that continued to exist during the third quarter of 2013. The average interest rate paid on interest-bearing liabilities was 0.34% for the third quarter of 2013, a decrease of 80 basis points from the 1.14% average interest rate paid in the third quarter of 2012.

Net interest margin (net interest income divided by average interest-earning assets) for the third quarter of 2013 was 4.10%, an increase of 28 basis points, compared to 3.82% for the third quarter of 2012.

Net interest income was \$14.9 million for the first nine months of 2013, a decrease of \$3.3 million, or 17.8%, from \$18.2 million for the same period in 2012. Interest income was \$17.8 million for the nine-month period ended September 30, 2013, a decrease of \$6.0 million, or 25.0%, from \$23.8 million for the same period in 2012. Interest income decreased between the periods primarily because of a \$97 million decrease in the average interest-earning assets and also because of a decrease in the average yields earned on 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 loan prepayments or non-renewals as a result of the Company's focus on improving credit quality, decreasing loan concentrations, managing net interest margin and improving capital ratios. The average yield earned on interest-earning assets was 4.25% for the first nine months of 2013, a decrease of 57 basis points from the 4.82% average yield for the same period of 2012. The decrease in the average yield is due to the continued low short-term interest rate environment that existed during the first nine months of 2013. The increase in domestic long-term mortgage rates that began during the second quarter of 2013 did not materially impact the average yield earned on interest-earning assets during the first nine months of 2013 since most of the mortgage loans originated by the Bank are sold into the secondary market and not placed in the loan portfolio.

Interest expense was \$2.9 million for the nine-month period ended September 30, 2013, a decrease of \$2.7 million, or 48.3%, from \$5.6 million for the same period in 2012. Interest expense decreased primarily because of a \$108 million decrease in the average interest-bearing liabilities between the periods, largely due to a decrease in the outstanding borrowings and brokered certificates of deposit. The decrease in borrowings and brokered certificates of deposit between the periods was the result of using the proceeds from loan principal payments to fund maturing borrowings and brokered certificates of deposit. Interest expense also decreased because of the lower interest rates paid on money market accounts and certificates of deposit due to the low short-term interest rate environment that continued to exist during the first nine months of 2013. The average interest rate paid on interest-bearing liabilities was 0.75% for the first nine months of 2013, a decrease of 45 basis points from the 1.20% average interest rate paid in the first nine months of 2012.

Net interest margin (net interest income divided by average interest-earning assets) was 3.56% for the nine-month period ended September 30, 2013, a decrease of 12 basis points, compared to 3.68% for the same nine-month period of 2012.

A summary of the Company's net interest margin for the three and nine-month periods ended September 30, 2013 and September 30, 2012 is as follows:

| <i>(Dollars in thousands)</i> | For the three month period ended | | | | | |
|--|----------------------------------|----------|--------|--------------------|----------|--------|
| | September 30, 2013 | | | September 30, 2012 | | |
| | Average | Interest | Yield/ | Average | Interest | Yield/ |
| | Outstanding | Earned/ | Rate | Outstanding | Earned/ | Rate |
| | Balance | Paid | | Balance | Paid | |
| Interest-earning assets: | | | | | | |
| Securities available for sale | \$90,499 | 222 | 0.97 % | \$76,631 | 292 | 1.52 % |
| Loans held for sale | 1,970 | 20 | 4.06 | 3,559 | 28 | 3.16 |
| Mortgage loans, net | 81,219 | 921 | 4.50 | 102,736 | 1,631 | 6.32 |
| Commercial loans, net | 265,097 | 3,853 | 5.77 | 326,177 | 4,761 | 5.81 |
| Consumer loans, net | 53,275 | 698 | 5.20 | 55,490 | 789 | 5.65 |
| Cash equivalents | 22,297 | 12 | 0.21 | 45,299 | 26 | 0.23 |
| Federal Home Loan Bank stock | 796 | 3 | 1.50 | 4,063 | 24 | 2.36 |
| Total interest-earning assets | 515,153 | 5,729 | 4.41 | 613,955 | 7,551 | 4.89 |
| Interest-bearing liabilities: | | | | | | |
| NOW accounts | 67,277 | 3 | 0.02 | 61,502 | 9 | 0.06 |
| Savings accounts | 43,934 | 8 | 0.07 | 39,998 | 16 | 0.16 |
| Money market accounts | 117,193 | 87 | 0.29 | 110,649 | 109 | 0.39 |
| Certificates | 131,358 | 273 | 0.82 | 194,831 | 576 | 1.18 |
| Brokered deposits | 9,327 | 33 | 1.40 | 21,519 | 94 | 1.73 |
| Advances and other borrowings | 283 | 0 | 0.00 | 70,000 | 855 | 4.86 |
| Total interest-bearing liabilities | 369,372 | | | 498,499 | | |
| Non-interest checking | 97,937 | | | 77,281 | | |
| Other non-interest bearing deposits | 1,123 | | | 1,139 | | |
| Total interest-bearing liabilities and non-interest bearing deposits | \$468,432 | 404 | 0.34 | \$576,919 | 1,659 | 1.14 |
| Net interest income | | \$5,325 | | | \$5,892 | |
| Net interest rate spread | | | 4.07 % | | | 3.75 % |
| Net interest margin | | | 4.10 % | | | 3.82 % |

| <i>(Dollars in thousands)</i> | For the nine month period ended | | | | | |
|-------------------------------|---------------------------------|----------|--------|--------------------|----------|--------|
| | September 30, 2013 | | | September 30, 2012 | | |
| | Average | Interest | Yield/ | Average | Interest | Yield/ |
| | Outstanding | Earned/ | Rate | Outstanding | Earned/ | Rate |

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| | Balance | Paid | | Balance | Paid | |
|--|-----------|----------|--------|-----------|----------|--------|
| Interest-earning assets: | | | | | | |
| Securities available for sale | \$91,744 | 685 | 1.00 % | \$89,466 | 1,091 | 1.63 % |
| Loans held for sale | 2,215 | 58 | 3.50 | 3,116 | 75 | 3.22 |
| Mortgage loans, net | 87,479 | 3,061 | 4.68 | 110,812 | 4,509 | 5.44 |
| Commercial loans, net | 276,889 | 11,817 | 5.71 | 348,497 | 15,476 | 5.93 |
| Consumer loans, net | 53,397 | 2,087 | 5.23 | 58,081 | 2,467 | 5.67 |
| Cash equivalents | 46,963 | 80 | 0.23 | 44,256 | 71 | 0.21 |
| Federal Home Loan Bank stock | 2,666 | 51 | 2.56 | 4,110 | 89 | 2.88 |
| Total interest-earning assets | 561,353 | 17,839 | 4.25 | 658,338 | 23,778 | 4.82 |
| Interest-bearing liabilities: | | | | | | |
| NOW accounts | 69,754 | 12 | 0.02 | 65,027 | 29 | 0.06 |
| Savings accounts | 44,215 | 27 | 0.08 | 39,616 | 53 | 0.18 |
| Money market accounts | 114,856 | 270 | 0.31 | 110,431 | 347 | 0.44 |
| Certificates | 145,530 | 997 | 0.92 | 209,720 | 1,927 | 1.26 |
| Brokered deposits | 11,675 | 120 | 1.37 | 41,621 | 726 | 2.33 |
| Advances and other borrowings | 40,681 | 1,485 | 4.88 | 70,000 | 2,544 | 4.85 |
| Total interest-bearing liabilities | 426,711 | | | 536,415 | | |
| Non-interest checking | 89,023 | | | 87,072 | | |
| Other non-interest bearing deposits | 1,099 | | | 1,156 | | |
| Total interest-bearing liabilities and non-interest bearing deposits | \$516,833 | 2,911 | 0.75 | \$624,643 | 5,626 | 1.20 |
| Net interest income | | \$14,928 | | | \$18,152 | |
| Net interest rate spread | | | 3.50 % | | | 3.62 % |
| Net interest margin | | | 3.56 % | | | 3.68 % |

Provision for Loan Losses

The provision for loan losses was (\$4.3) million for the third quarter of 2013, a decrease of \$5.9 million, compared to \$1.6 million for the third quarter of 2012. The provision for loan losses decreased in the third quarter primarily because of improving values of the underlying collateral supporting commercial real estate loans in the third quarter of 2013 when compared to the third quarter of 2012. The provision also decreased because of a decrease in the outstanding loan portfolio balances, a decrease in the reserve percentages on certain risk classifications as a result of an internal analysis of the loan portfolio, an improvement in the classifications of certain risk rated loans, and the recoveries received during the quarter on previously charged off loans.

The provision for loan losses was (\$4.9) million for the first nine months of 2013, a decrease of \$7.4 million, from \$2.5 million for the same nine-month period in 2012. The provision for loan losses decreased in the first nine months of 2013 primarily because of improving values of the underlying collateral supporting commercial real estate loans in the first nine months of 2013 when compared to the same period of 2012. The provision also decreased because of a decrease in the outstanding loan portfolio balances, a decrease in the reserve percentages on certain risk classifications as a result of an internal analysis of the loan portfolio, an improvement in the classifications of certain risk rated loans, and the recoveries received during the first nine months of 2013 on previously charged off loans.

A reconciliation of the Company's allowance for loan losses for the three and nine-month periods ended September 30, 2013 and September 30, 2012 is summarized as follows:

| <i>(Dollars in thousands)</i> | For the three months ended | |
|-------------------------------|-------------------------------|-----------------------|
| | September 30, 2013 | September 30, 2012 |
| Balance at June 30, | \$20,359 | \$ 20,519 |
| Provision | (4,330) | 1,584 |
| Charge offs: | | |
| One-to-four family | 0 | 0 |
| Consumer | (374) | (163) |
| Commercial business | (2) | (168) |
| Commercial real estate | (50) | (1,535) |
| Recoveries | 902 | 225 |
| Balance at September 30, | \$16,505 | \$ 20,462 |
| General allowance | \$9,953 | \$ 15,965 |
| Specific allowance | 6,552 | 4,497 |
| | \$16,505 | \$ 20,462 |

| <i>(Dollars in thousands)</i> | For the nine months ended | |
|-------------------------------|------------------------------|-----------------------|
| | September 30, 2013 | September 30, 2012 |
| Balance at January 1, | \$21,608 | \$ 23,888 |
| Provision | (4,850) | 2,544 |
| Charge offs: | | |
| One-to-four family | (200) | 0 |
| Consumer | (475) | (921) |
| Commercial business | (606) | (1,997) |
| Commercial real estate | (911) | (5,719) |
| Total charge offs | (2,192) | (8,637) |
| Recoveries | 1,939 | 2,667 |
| Balance at September 30, | \$ 16,505 | \$ 20,462 |

Non-Interest Income

Non-interest income was \$1.8 million for the third quarter of 2013, a decrease of \$0.3 million, or 13.8%, from \$2.1 million for the same period of 2012. Gain on sales of loans decreased \$0.5 million primarily because of a decrease in single family loan originations due to the higher long-term mortgage interest rate environment that existed in the third quarter of 2013. Fees and service charges increased \$0.1 million primarily because of an increase in overdraft charges and debit card fees between the periods. Other non-interest income increased \$0.1 million primarily because of an increase in the sales of uninsured investment products.

Non-interest income was \$5.7 million for the first nine months of 2013, a decrease of \$0.9 million, or 14.1%, from \$6.6 million for the same period in 2012. Gain on sale of branch office was \$0 for the first nine months of 2013, compared to the \$0.6 million recorded in the same period of 2012 as a result of the sale of the Toledo, Iowa branch in the first quarter of 2012. Gain on sales of loans decreased \$0.7 million between the periods primarily because of a decrease in the sales of commercial government guaranteed loans during the first nine months of 2013 when compared to the same period in 2012. These decreases in non-interest income were partially offset by an increase of \$0.1 million in fees and service charges due to increased overdraft charges, \$0.1 million increase in mortgage servicing income as a result of servicing more loans, and \$0.1 million increase in other income as a result of an increase in the sales of uninsured investment products.

Non-Interest Expense

Non-interest expense was \$5.3 million for the third quarter of 2013, a decrease of \$0.5 million, or 8.7%, from \$5.8 million for the same period of 2012. Other non-interest expenses decreased \$0.3 million primarily because of decreased legal expenses relating to real estate owned and loan collection efforts and mortgage servicing rights amortization expense. The decrease in mortgage servicing rights amortization expense is the result of fewer refinanced mortgage loans in the quarter due to the increase in long-term mortgage rates that were experienced during the quarter. Deposit insurance costs decreased \$0.2 million primarily because of a decrease in assets between the periods. The gain on real estate owned increased \$0.1 million primarily because of an increase in the gains recognized on the properties sold. Occupancy expense increased \$0.1 million as a result of increased repair and maintenance expenses incurred during the quarter when compared to the same period of 2012.

Non-interest expense was \$16.7 million for the first nine months of 2013, a decrease of \$1.7 million, or 9.5%, from \$18.4 million for the same period in 2012. The gain on real estate owned increased \$0.5 million primarily because of an increase in the gains recognized on the properties sold. Compensation and benefits expense decreased \$0.4 million primarily because of a decrease in employees between the periods due to certain branch closures and our continued focus on reducing expenses. Other non-interest expense decreased \$0.5 million because of decreased real estate taxes and other expenses related to other real estate owned. Deposit insurance costs decreased \$0.2 million primarily because of a decrease in assets between the periods.

Income Tax Expense

Income tax expense was \$0.2 million for the third quarter and first nine months of 2013, an increase of \$0.2 million from the same periods of 2012 when no income tax expense was recorded. The income tax expense that was recorded in the third quarter and first nine months of 2013 relates to alternative minimum tax amounts that are due since only a portion of the outstanding net operating loss carry forwards can be used to offset current income under the current alternative minimum tax rules. No regular income tax expense was recorded for the third quarter of 2013 because the Company continued to maintain a valuation reserve against the entire deferred tax asset balance at September 30, 2013. The Company originally recorded a deferred tax asset valuation reserve against its entire deferred tax asset balance in the second quarter of 2010. Based on the recent improvements in the financial performance of the Company, it is anticipated that the Company will be in a three year cumulative gain position at December 31, 2013 and would be eligible to eliminate a significant portion of the \$15.9 million valuation reserve that existed at

September 30, 2013 against the deferred tax asset. Any reversal of the deferred tax asset valuation reserve would result in an increase in the book value of the Company's common stock and a corresponding credit provision to income tax expense. The timing and amount of any adjustment to the deferred tax asset valuation reserve will be dependent on the Company obtaining a three year cumulative gain position and an evaluation of both the positive and negative evidence relating to the ultimate realizability of the deferred tax asset as noted in the Critical Accounting Estimates-Income Taxes.

Net Income Available to Common Shareholders

Net income available to common shareholders was \$5.5 million for the third quarter of 2013, an increase of \$5.3 million from the \$0.2 million net income available to common shareholders in the third quarter of 2012. The net income available to common shareholders was \$7.0 million for the first nine months of 2013, an increase of \$4.6 million from the \$2.4 million net income available to common shareholders in the same period of 2012. The net income available to common shareholders increased between the periods primarily because of the increase in net income between the periods. The Company has deferred the last eleven quarterly dividend payments, beginning with the February 15, 2011 dividend payment, on its Fixed Rate, Series A, Cumulative Perpetual Preferred Stock, that was originally issued to the United States Treasury Department as part of the TARP Capital Purchase Program (the "Preferred Stock"). The Preferred Stock is currently held by unaffiliated third party investors. Under the terms of the certificate of designations for the Preferred Stock, dividend payments may be deferred but the dividend is cumulative and compounds quarterly while unpaid. The deferred dividend payments of \$3.8 million have been accrued for payment in the future and are being reported for the deferral period as a preferred dividend requirement that is deducted from net income for financial statement purposes to arrive at the net income available to common shareholders. The current stated dividend rate on the Preferred Stock of 5% per annum will increase to 9% per annum on February 15, 2014.

Basic earnings per common share was \$1.38 and \$0.04 for the third quarter of 2013 and 2012, respectively, and diluted earnings per common share was \$1.27 and \$0.04 for the same periods, respectively. Basic earnings per common share was \$1.76 and \$0.62 for the first nine months of 2013 and 2012, respectively, and diluted earnings per common share was \$1.65 and \$0.61 for the same periods, respectively. The increased spread between basic and diluted earnings per common share for the third quarter and first nine months of 2013 as compared to the same periods of 2012 is primarily due to increased net income and an increase in the price of our common stock, which resulted in a larger number of stock options and warrants having a lower exercise price than the market price of our common stock.

FINANCIAL CONDITION***Non-Performing Assets***

The following table summarizes the amounts and categories of non-performing assets, which consist of non-performing loans and foreclosed and repossessed assets, in the Bank's portfolio and loan delinquency information as of the end of the two most recently completed quarters and December 31, 2012.

| <i>(Dollars in thousands)</i> | September 30, 2013 | June 30, 2013 | December 31, 2012 | | | |
|--|------------------------------|----------------------|-----------------------------|---|-------|---|
| Non-Performing Loans: | | | | | | |
| One-to-four family real estate | \$ 1,626 | \$2,091 | \$ 2,492 | | | |
| Commercial real estate | 19,578 | 21,533 | 25,543 | | | |
| Consumer | 442 | 1,462 | 300 | | | |
| Commercial business | 711 | 755 | 1,640 | | | |
| Total | 22,357 | 25,841 | 29,975 | | | |
| Foreclosed and Repossessed Assets: | | | | | | |
| One-to-four family real estate | 1,082 | 707 | 1,595 | | | |
| Commercial real estate | 7,817 | 8,716 | 9,000 | | | |
| Total non-performing assets | \$ 31,256 | \$35,264 | \$ 40,570 | | | |
| Total as a percentage of total assets | 5.56 | % | 6.29 | % | 6.21 | % |
| Total non-performing loans | \$ 22,357 | \$25,841 | \$ 29,975 | | | |
| Total as a percentage of total loans receivable, net | 5.68 | % | 6.22 | % | 6.60 | % |
| Allowance for loan losses to non-performing loans | 73.83 | % | 78.79 | % | 72.09 | % |
| Delinquency Data: | | | | | | |
| Delinquencies ⁽¹⁾ | | | | | | |
| 30+ days | \$ 2,516 | \$5,820 | \$ 2,739 | | | |
| 90+ days ⁽²⁾ | 0 | 0 | 7,423 | | | |
| Delinquencies as a percentage of Loan and lease portfolio ⁽¹⁾ | | | | | | |
| 30+ days | 0.53 | % | 1.22 | % | 0.57 | % |
| 90+ days | 0.00 | % | 0.00 | % | 1.55 | % |

⁽¹⁾ Excludes non-accrual loans.

⁽²⁾ Loans delinquent for 90 days and over are generally non-accruing and are included in the Company's non-performing asset total unless they are well secured and in the process of collection.

Total non-performing assets were \$31.3 million at September 30, 2013, a decrease of \$4.0 million, or 11.4%, from \$35.3 million at June 30, 2013. Non-performing loans decreased \$3.5 million and foreclosed and repossessed assets decreased \$0.5 million during the third quarter of 2013. The non-performing loan and foreclosed and repossessed

asset activity for the quarter was as follows:

(Dollars in thousands)

| Non-performing loans | | Foreclosed and repossessed assets | |
|----------------------------------|----------|--|---------|
| June 30, 2013 | \$25,841 | June 30, 2013 | \$9,423 |
| Classified as non-performing | 1,312 | | |
| Charge offs | (426) | Transferred from non-performing loans | 639 |
| Principal payments received | (2,814) | Real estate sold | (1,350) |
| Classified as accruing | (917) | Net gain on sale of assets | 297 |
| Transferred to real estate owned | (639) | Write downs and payments | (110) |
| September 30, 2013 | \$22,357 | September 30, 2013 | \$8,899 |

The decrease in non-performing loans during the third quarter of 2013 relates primarily to principal payments received and loans being classified as accruing during the period. Of the \$2.8 million in principal payments received, \$1.2 million related to the payoff of a non-performing multi-family construction loan that was refinanced with another financial institution and \$1.6 million related to additional principal payments received on various construction and development loans as a result of various types of real estate sales including building lots, land, and single family homes. Of the \$0.9 million in loans that were classified as accruing, \$0.7 million related to various commercial real estate loans and \$0.2 million related to a single family loan. These decreases in non-performing loans were partially offset by loans that were newly classified as non-performing during the period. Of the \$1.3 million in loans newly classified as non-performing, \$1.1 million related to commercial real estate loans, \$0.1 million related to commercial business loans, and \$0.1 million related to consumer loans.

Total non-performing assets were \$31.3 million at September 30, 2013, a decrease of \$9.3 million, or 23.0%, from \$40.6 million at December 31, 2012. Non-performing loans decreased \$7.6 million and foreclosed and repossessed assets decreased \$1.7 million during the first nine months of 2013. The non-performing loan and foreclosed and repossessed asset activity for the first nine months of 2013 was as follows:

(Dollars in thousands)

| Non-performing loans | | Foreclosed and repossessed assets | |
|----------------------------------|----------|--|----------|
| December 31, 2012 | \$29,975 | December 31, 2012 | \$10,595 |
| Classified as non-performing | 4,792 | Transferred from non-performing loans | 876 |
| Charge offs | (2,149) | Other foreclosures/repossessions | 687 |
| Principal payments received | (7,802) | Real estate sold | (3,629) |
| Classified as accruing | (1,583) | Net gain on sale of assets | 998 |
| Transferred to real estate owned | (876) | Write downs and payments | (628) |
| September 30, 2013 | \$22,357 | September 30, 2013 | \$8,899 |

The following table summarizes the number of lending relationships and types of commercial real estate loans that were non-performing as of the end of the two most recently completed quarters and December 31, 2012.

| | | <i>(Dollars in thousands)</i> | | | | <i>(Dollars in thousands)</i> | |
|-------------------|----|-------------------------------|------------------------------|--------------------|------------------------------|-------------------------------|------------------------------|
| | | # of relationships | Principal Amount of Loans at | # of relationships | Principal Amount of Loans at | # of relationships | Principal Amount of Loans at |
| Property Type | | September 30, 2013 | | June 30, 2013 | | September 30, 2013 | |
| Developments/land | 8 | \$19,413 | 9 | \$20,956 | 9 | \$24,339 | 2012 |
| Retail | 2 | 165 | 1 | 66 | 2 | 386 | |
| Restaurants/bar | 0 | 0 | 1 | 511 | 1 | 547 | |
| Other buildings | 0 | 0 | 0 | 0 | 3 | 271 | |
| | 10 | \$19,578 | 11 | \$21,533 | 15 | \$25,543 | |

The decrease in the non-performing commercial real estate loans from June 30, 2013 is due primarily to principal payments received on construction and development loans during the quarter as a result of various types of real estate sales including building lots, land, and single family houses.

Dividends

The declaration of dividends is subject to, among other things, the Company's financial condition and results of operations, the Bank's compliance with its regulatory capital requirements, tax considerations, industry standards, economic conditions, regulatory restrictions, general business practices and other factors. Under the Bank Supervisory Agreement, no dividends can be declared or paid by the Bank to the Company without prior regulatory approval. The payment of dividends by the Company is dependent upon the Company having adequate cash or other assets that can be converted to cash to pay dividends to its stockholders. In addition, under the terms of the Company's Supervisory Agreement, the Company may not declare or pay any cash dividends, or purchase or redeem any capital stock, without prior notice to, and consent of its regulator. The Company suspended the dividend payments to common stockholders in the fourth quarter of 2008 due to the net operating losses experienced and the challenging economic environment. The Company has deferred the last eleven quarterly dividend payments, beginning with the February 15, 2011 dividend payment, on its Preferred Stock. Under the terms of the certificate of designations for the Preferred Stock, dividend payments may be deferred, but the dividend is cumulative and compounds quarterly during the deferral period. As of August 15, 2013, cumulative deferred dividend payments totaling \$3.8 million have been accrued for payment in the future and are being reported for the deferral period as a preferred dividend requirement that has been deducted from income for financial statement purposes to arrive at the net income available to common shareholders. Commencing February 15, 2014, the rate at which Preferred Stock dividends accrue on the original Preferred Stock investment will increase from 5% to 9%. Further, while dividends on the Preferred Stock are in arrears, no dividend may be paid on the common stock of the Company.

LIQUIDITY AND CAPITAL RESOURCES

For the nine months ended September 30, 2013, the net cash provided by operating activities was \$17.2 million. The Company collected \$11.0 million from the maturities of securities, \$4.2 million from principal repayments on securities, \$3.3 million from the redemption of FHLB stock, and \$3.7 million in proceeds from the sale of real estate. The Company purchased securities of \$20.1 million, and purchased premises and equipment of \$0.3 million. Net loans receivable decreased \$53.6 million due primarily to commercial loan prepayments and non-renewals. The Company had a net decrease in deposit and customer escrow balances of \$28.6 million (primarily in brokered and internet deposits), received \$12.0 million in proceeds from borrowings, and repaid \$82.0 million in borrowings.

The Company has certificates of deposits with outstanding balances of \$81.5 million that come due over the next 12 months, of which \$7.6 million were obtained from brokers. Based upon past experience, management anticipates that the majority of the deposits will renew for another term, with the exception of the brokered deposits that are not anticipated to renew due to the Company's desire to reduce the amount of outstanding brokered deposits. In addition, based on a regulatory directive, the Bank may not renew existing brokered deposits, or accept new brokered deposits without the prior consent of the OCC. The Company believes that deposits that do not renew will be repaid with proceeds from loan principal payments or replaced with a combination of other customer's deposits, FHLB advances, or Federal Reserve Bank borrowings. Proceeds from the sale of securities could also be used to fund unanticipated outflows of deposits.

The Company had four deposit customers with aggregate deposits greater than \$5.0 million as of September 30, 2013. The \$47.0 million in funds held by these customers may be withdrawn at any time, however, management does not anticipate that these deposits will be withdrawn from the Bank over the next twelve months. If these deposits were to be withdrawn, we would expect them to be replaced with deposits from other customers or brokers, subject to regulatory approval. FHLB advances, Federal Reserve borrowings or proceeds from the sale of securities could also be used to replace unanticipated outflows of large checking and money market deposits.

At September 30, 2013, the Bank had the ability to draw additional borrowings from the FHLB of \$109.3 million based upon the collateral pledged, subject to a requirement to purchase additional FHLB stock and the FHLB agreeing to lend. The Bank also has the ability to draw additional borrowings of \$65.1 million from the Federal Reserve Bank, based upon the loans pledged with them. The credit policy of the FHLB or the FRB relating to the collateral value of the loans collateralizing the available lines of credit may change at any time such that the current collateral pledged to secure the available lines of credit is no longer acceptable or the formulas for determining the excess pledged collateral may change. If the credit policy of the FHLB or the FRB were to change it could limit the borrowing capacity of the Bank from these liquidity sources in the future.

The Company's primary source of cash is dividends from the Bank and the Bank is restricted under the Bank Supervisory Agreement from paying dividends to the Company without obtaining prior regulatory approval. During the third quarter of 2013, the Bank requested and received approval from the OCC to pay, and paid a dividend of \$1.0 million to the Company. At September 30, 2013, the Company had \$1.2 million in cash and other assets that could

readily be turned into cash. The primary use of cash by the Company is the payment of expenses and, when permitted, dividends on the Preferred Stock. The Company believes it has adequate cash to meet its anticipated expenses through the fourth quarter of 2014 but thereafter the Company will need additional cash resources to meet its cash needs. It is anticipated that in 2014 the Company will request the consent of applicable regulators in order for the Bank to declare and pay a dividend to the Company in an amount sufficient to meet its short term cash needs beyond 2014. There's no assurance regulators would consent to any such dividend in which case we would need to seek external sources of funding.

The Company has deferred the last eleven quarterly dividend payments, beginning with the February 15, 2011 dividend payment, on the Preferred Stock and has determined that it will defer the November 15, 2013 payment. The deferred dividend payments have been accrued for payment in the future and are being reported for the deferral period as a preferred dividend requirement that is deducted from income for financial statement purposes to arrive at the net income available to common shareholders. The amount of the compounding 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 or otherwise reacquired. Under the terms of the certificate of designations for the Preferred Stock, dividend payments may be deferred, but the dividend is cumulative and compounds quarterly during the deferral period. In addition, if the Company fails to pay dividends for six quarters the holders of the Preferred Stock have the right to appoint two representatives to the Company's board of directors. The Treasury did not exercise that right.

On February 8, 2013, the Treasury sold the Preferred Stock issued by the Company to unaffiliated third party investors in a private transaction. The Company has been advised that the current holders of substantially all of the Preferred Stock have entered into agreements with the FRB pursuant to which they have each agreed not to take actions, without the consent of the FRB, which might be construed as exercising or attempting to exercise a controlling influence over the management or policies of the Company or the Bank, including exercise of any right to elect any representatives to the Company's board of directors. Further, while dividends on the Preferred Stock are in arrears, no dividend may be paid on the common stock of the Company. Under the terms of the Company's and Bank's Supervisory Agreements with their federal banking regulators, neither the Company nor the Bank may declare or pay any cash dividends, or purchase or redeem any capital stock, without prior notice to, and consent of these regulators.

As required by the Company's Supervisory Agreement, the Company submitted an updated two-year capital plan in January of 2013 that the FRB may make comments on, and to which it may require revisions. The Company must operate within the parameters of the final capital plan and is required to monitor and submit periodic reports on its compliance with the plan. In addition, the OCC has established an IMCR for the Bank. An IMCR requires a bank to establish and maintain levels of capital greater than those generally required for a bank to be classified as "well-capitalized." Effective December 31, 2011, the Bank was required to establish, and subsequently maintain, core capital at least equal to 8.5% of adjusted total assets, which was in excess of the Bank's 7.14% core capital to adjusted total assets ratio at December 31, 2011. In February 2012, the Bank received a notice from the OCC arising out of its failure to establish and maintain its IMCR of 8.5% core capital to adjusted total assets at December 31, 2011. In accordance with this notice, by April 30, 2012, the OCC required the Bank to submit a further written capital plan of how it intended to achieve and maintain its IMCR, and a contingency plan in the event the IMCR was not achieved through the Bank's primary plan. Because of the improved financial results and the decrease in assets experienced since December 31, 2011, the Bank's core capital ratio improved to 12.71% at September 30, 2013.

In order to improve its capital ratios and maintain compliance with its IMCR, the Bank is, among other things, working to improve its financial results, reduce non-performing assets, and decrease the asset size of the Bank. These actions have resulted, and may result in changes in the Bank's assets, liabilities and earnings, some of which may be material, during the period in which the action is taken or is consummated or over a longer period of time.

The Company also serves as a source of capital, liquidity and financial support to the Bank. In light of the operating performance of the Bank, the need for continued compliance with the Bank and Company Supervisory Agreements and the Bank IMCR and the Company's other liquidity and capital needs, including expenses and accumulating and unpaid dividends on the Preferred Stock, the stated rate of which increases in February 2014 from 5% to 9% per annum, compounding quarterly, the Company, subject to prevailing capital market conditions, applicable regulatory approvals and other factors, may find it prudent or be required by supervising bank regulators to raise additional capital and to pursue alternatives to restructure, reacquire or recapitalize outstanding Preferred Stock, in each case through, in whole or in part, issuance of its common stock or other equity securities. In addition to the requirements of the Supervisory Agreements and the IMCR, regulators have placed increasing emphasis on the amount of common equity as a component of core bank capital, and recently approved revisions to the capital regulations (described below) incorporating specific levels of common equity capital. Regulations would also require regulatory capital to meet required levels on a consolidated basis. Further, additional capital would potentially permit the Company to return to a strategy of growing Bank assets. Depending on circumstances, if it were to raise capital, the Company may

deploy it to the Bank for general banking purposes, or may retain some or all of the capital for use at the holding company level.

On April 23, 2013, the Company's shareholders approved a five million share increase in the number of authorized common shares. If the Company issues additional shares of common stock or other equity securities, it could dilute the ownership interests of existing stockholders and, given our current common stock trading price, raising additional capital could dilute the per share book value of the Company's common stock, could dilute the Company's earnings per share and could result in a change of control of the Company and the Bank. Investors in newly issued securities may also have rights, preferences and privileges senior to the Company's current stockholders, which may adversely impact the Company's current stockholders. The Company's ability to issue equity securities will depend on, among other factors, conditions in the capital markets at that time, which are outside of its control, and on the Company's financial performance. Accordingly, the Company may not be able to issue capital on favorable economic terms, or other terms acceptable to it.

If the Company or the Bank cannot satisfactorily address their respective capital needs as they arise, the Company's ability to maintain or expand its operations, their ability to meet the Company's capital plan, otherwise maintain compliance with the Supervisory Agreements and maintain the core capital ratio in the Bank IMCR, the Company's ability to limit or reverse the accumulation of and increased rate of unpaid preferred stock dividends, and to operate without additional regulatory or other restrictions, and its operating results, could be materially adversely affected.

The capital requirements of the Company and the Bank will be affected in the future by regulatory changes approved in the final rules issued in July 2013 by the FRB and the OCC to establish an integrated regulatory capital framework for implementing the Basel III reforms of the Basel Committee on Banking Supervision for the Bank of International Settlements. The new requirements, which will be effective beginning on January 1, 2015, will, among other things, apply a strengthened set of capital requirements to both the Bank and the Company, including new requirements relating to common equity as a component of core capital and as a "capital conservation buffer" against risk, and a higher minimum core capital requirement, and will revise the rules for calculating risk-weighted assets for purposes of such requirements. The final rules make corresponding revisions to the prompt corrective action framework. Under the final rules, certain changes including the new capital ratio and buffer requirements will be phased in incrementally, with full implementation scheduled for January 1, 2019.

Market Risk

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

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

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

The following table discloses the projected changes in market value to the Company's interest-earning assets and interest-bearing liabilities based upon incremental 100 basis point changes in interest rates from interest rates in effect on September 30, 2013.

| Other than trading portfolio (Dollars in thousands) | Market Value | | | |
|--|--------------|---------|---------|---------|
| Basis point change in interest rates | -100 | 0 | +100 | +200 |
| Total market risk sensitive assets | \$572,593 | 564,873 | 555,742 | 544,174 |
| Total market risk sensitive liabilities | 472,655 | 452,326 | 440,034 | 425,651 |
| Off-balance sheet financial instruments | (128) | 0 | (4) | (0) |
| Net market risk | \$100,066 | 112,547 | 115,712 | 118,523 |
| Percentage change from current market value | (11.09)% | 0.00 % | 2.81 % | 5.31 % |

The preceding table was prepared utilizing the following assumptions (Model Assumptions) regarding prepayment and decay ratios, which were determined by management based upon their review of historical prepayment speeds and future prepayment projections. Fixed rate loans were assumed to prepay at annual rates of between 5% to 63%, depending on the note rate and the period to maturity. Adjustable rate mortgages (ARMs) were assumed to prepay at annual rates of between 18% and 138%, 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 13% and money market accounts were assumed to decay at an annual rate of 9%. Non-interest checking and NOW accounts were assumed to decay at an annual rate of 6%. Commercial NOW accounts and MMDA accounts were assumed to decay at an annual rate of 13% and 16%, respectively. Commercial non-interest checking accounts were assumed to decay at an annual rate of 13%. FHLB advances were projected to be called at the first call date where the projected interest rate on similar remaining term advances exceeded the interest rate on the callable advance or investment.

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

Asset/Liability Management

The Company's management reviews the impact that changing interest rates will have on its net interest income projected for the next twelve months to determine if its current level of interest rate risk is acceptable. The following table projects the estimated annual impact on net interest income during the 12 month period ending September 30, 2014 of immediate interest rate changes called rate shocks.

(Dollars in thousands)

| Rate Shock Basis Points | Projected Change in Net Interest Income | Percentage Change | |
|-------------------------|---|-------------------|---|
| +200 | \$ 2,084 | 11.34 | % |
| +100 | 1,034 | 5.62 | |

| | | |
|------|----------|---------|
| 0 | 0 | 0.00 |
| -100 | (1,474) | (8.02) |

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

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

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

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

Off-Balance Sheet Arrangements

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

Item 3: Quantitative and Qualitative Disclosures about Market Risk

Included in Part I, Item 2 under "Market Risk" and "Asset/Liability Management."

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

Changes in internal controls. There was no change in the Company's internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) of the Exchange Act) during the Company's most recently completed fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

HMN FINANCIAL, INC.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings.

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

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

Submission of a written plan by May 31, 2011 for enhancing the consolidated capital of the Company for the period ending December 31, 2012 and review of performance no less than quarterly along with reports to the FRB (as successor to the OTS' role as regulator of the Company) within 45 days after the end of each calendar quarter. The plan submitted by the Company prior to May 31, 2011 focused on improvement in capital levels primarily through improved earnings, reduction in non-performing assets and reduction in total assets. As required, the Company submitted updated two-year capital plans in January 2012 and 2013.

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

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

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

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

Submission of a business plan by May 31, 2011, addressing strategies for supporting the Bank's risk profile, improving earnings and profitability and stress testing. The Bank's Board is to review performance no less than quarterly and report to the OCC (as successor to the OTS's role as regulator of the Bank) within 45 days after the end of each calendar quarter. The plan submitted by the Bank prior to May 31, 2011 focused on improvement in capital levels primarily through improved earnings, reduction in non-performing assets and reduction in total assets. The OCC accepted the submitted plan with the expectation that the Bank would be in adherence with the OCC's Notification of Establishment of Higher Minimum Capital Ratios, dated August 8, 2011, requiring a minimum core capital ratio of 8.5% by December 31, 2011. As required, the Bank submitted updated two-year business plans in January 2012 and 2013.

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

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

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

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

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

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

The Bank may not declare or pay any dividends or make any other capital distributions without providing advance request to the OCC and receiving written approval. The Supervisory Agreement also limits the Bank's growth in total assets in excess of specified amounts without prior regulatory approval. The Bank's assets grew in excess of the allowable amount in the third quarter of 2011, the fourth quarter of 2012, and the third quarter of 2013; however, the Bank obtained prior approval from the OCC.

Limits are placed on contractual arrangements with third parties and contracts dealing with compensation or benefits with any directors or officers and the Bank is prevented from making any golden parachute payments to directors, officers and employees.

The Company and Bank timely submitted all plans and programs required by the Supervisory Agreements. The Company believes that it and the Bank were in compliance with all provisions of the Supervisory Agreements at September 30, 2013, and at all times prior to that time have been in compliance, except for their failure at December 31, 2011 to meet the earnings and capital forecasts contained in their respective capital and business plans, and the failure of the Bank at December 31, 2011 to meet its Individual Minimum Capital Requirement, as described below. The applicable regulator may comment on and require revision of any submitted plan, program or policy. Neither the Company nor the Bank have taken any actions, or sought approval for such actions, where prior regulatory approval is required by the Supervisory Agreements other than the restriction related to asset growth and changes to the business plan. In the third quarter of 2011, the fourth quarter of 2012, and the third quarter of 2013, the Bank requested and obtained a non-objection waiver from the OCC related to the unanticipated growth in assets during the quarters in an

amount greater than the net interest credited on deposit liabilities during the prior quarter. The Bank also received no supervisory objection to the change in the previously submitted business plan as a result of the increase in assets. The increase in assets was due to unanticipated increases in commercial deposits during the third quarter of 2011, the fourth quarter of 2012, and the third quarter of 2013, as a result of increased cash being held by a few of the Bank's commercial deposit customers.

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

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

The OCC has established an IMCR for the Bank. An IMCR requires a bank to establish and maintain levels of capital greater than those generally required for a bank to be classified as “well-capitalized.” Effective December 31, 2011, the Bank was required to establish, and subsequently maintain, core capital at least equal to 8.5% of adjusted total assets, which was in excess of the Bank’s 7.14% core capital to adjusted total assets ratio at December 31, 2011. In February 2012, the Bank received a notice from the OCC arising out of its failure to establish and maintain its IMCR of 8.5% core capital to adjusted total assets at December 31, 2011. By April 30, 2012, the Bank submitted to the OCC a further written capital plan of how it would achieve and maintain its IMCR, and a contingency plan in the event the IMCR was not achieved through the Bank’s primary plan. As a result of a decrease in assets and improved financial results since December 31, 2011, the Bank’s core capital to adjusted total assets ratio improved to 12.71% at September 30, 2013.

Under applicable banking regulations, the failure to satisfy the terms of the Supervisory Agreements and the IMCR, and failure to otherwise comply with applicable requirements as they arise, could subject the Company, the Bank and its directors and officers to such restrictions, legal actions or sanctions as the OCC or FRB consider appropriate. Possible sanctions include, among others, (i) the imposition of one or more cease and desist orders requiring corrective action, which are enforceable directives that may address any aspect of the Company or Bank management, operations or capital, including requirements to change management, raise equity capital, dispose of assets or effect a change of control; (ii) civil money penalties; and (iii) downgrades in the capital adequacy status of the Company and the Bank.

Item 1A. Risk Factors

Other than as noted below, there have been no material changes to the Company’s risk factors contained in its Annual Report on Form 10-K for the year ended December 31, 2012. For a further discussion of our Risk Factors, see Part I, Item 1.A. of the Company’s Annual Report on Form 10-K for the year ended December 31, 2012.

The Company and the Bank operate in a highly regulated environment and may be adversely affected by changes in federal and state laws and regulations, including recent changes under federal law.

The Company and the Bank are subject to extensive examination, supervision and comprehensive regulation by federal bank regulatory agencies. Banking regulations are primarily intended to protect depositors’ funds, federal deposit insurance funds, and the banking system and the financial system as a whole, and not holders of our common stock. These regulations affect our lending practices, capital structure, investment practices, dividend policy, and growth, among other things. See Item 1 “Business – Regulation and Supervision” in the Company’s Annual Report on Form 10-K for the year ended December 31, 2012 for information regarding regulation affecting the Bank and the Company.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”) and the Basel III reforms of the Basel Committee on Banking Supervision of the Bank for International Settlements (“Basel III”) are changing the bank regulatory structure and affecting the lending, deposit, investment, trading and operating activities of financial institutions and their holding companies, including the Bank and the Company. The Dodd-Frank Act transferred the regulatory powers of the former OTS to other agencies as of July 21, 2011 (the “Transfer Date”). The OCC became the primary federal regulator for the Bank and the FRB became the primary federal regulator for the Company and its nondepository subsidiaries, and rulemaking with respect to consumer financial protection functions was transferred to the Consumer Financial Protection Bureau (the “CFPB”). The Dodd-Frank Act provides that all orders, resolutions, determinations, agreements, and regulations, interpretive rules, other interpretations, guidelines, and other advisory materials issued, made, prescribed, or allowed to become effective by the OTS on or before the Transfer Date with respect to savings and loan holding companies and their non-depository subsidiaries, and with respect to savings associations, remain in effect and are enforceable until modified, terminated, set aside, or superseded in accordance with applicable law by the FRB or the OCC, as applicable, by any court of competent jurisdiction, or by operation of law. Accordingly, the Supervisory Agreement entered into by the Company with the OTS is enforced by the FRB and the Supervisory Agreement entered into by the Bank with the OTS is enforced by the OCC.

The Dodd-Frank Act requires various federal agencies, including the FRB, the OCC and the CFPB, to adopt a broad range of new implementing rules and regulations. The federal agencies were given significant discretion in drafting the implementing rules and regulations. In addition, many of the requirements called for in the Dodd-Frank Act are being implemented over the course of several years. Given the uncertainty associated with the manner in which the provisions of the Dodd-Frank Act will be implemented by the various regulatory agencies and through regulations, the full extent of the impact such requirements will have on our operations remains unclear. The changes resulting from the Dodd-Frank Act may significantly impact the profitability of business activities, require material changes to certain business practices, or otherwise adversely affect our business, and will impose more stringent capital, liquidity and leverage requirements.

The capital requirements of the Company and the Bank will be affected in the future by regulatory changes approved in final rules issued in July 2013 by the FRB and the OCC to establish an integrated regulatory capital framework for implementing Basel III and changes required by the Dodd-Frank Act. The new requirements, which, with respect to the Company and the Bank, will become effective beginning in January 2015, will, among other things, apply a strengthened set of capital requirements to both the Bank and the Company, including new requirements relating to common equity as a component of core capital and as a “capital conservation buffer” against risk, and a higher minimum core capital requirement, and will revise the rules for calculating risk-weighted assets for purposes of such requirements. The final rules make corresponding revisions to the prompt corrective action framework. Under the final rules, certain changes including the new capital ratio and buffer requirements will be phased in incrementally, with full implementation scheduled for January 1, 2019.

In implementing its new authority over savings and loan holding companies and their non-depository subsidiaries, in 2011, the FRB promulgated a new Regulation LL, which largely duplicated provisions of former OTS regulations. While many of the changes were non-substantive, Regulation LL replaced the OTS rules and guidance addressing when a party is deemed to “control” or not “control” a savings association with somewhat more restrictive FRB rules that apply to bank holding companies. The most likely impact of this change will be for investors interested in making passive investments in savings and loan holding companies. Such investors may be subject to additional requirements that were previously not applicable to savings associations or their holding companies. Regulation LL also states that a savings and loan holding company such as the Company must serve as a source of financial and managerial strength to its subsidiary savings associations and may not conduct its operations in an unsafe and unsound manner. Although these concepts are consistent with former OTS policy, the Dodd-Frank Act placed the requirement in statute and Regulation LL reflects this requirement. The extent and timing of any such substantive changes that may have an impact on the Company’s capital requirements and liquidity remain difficult to predict at this time.

The FRB has announced that it will assess the condition, performance and activities of savings and loan holding companies in a manner that is consistent with its established risk-based approach regarding bank holding company supervision to ensure that savings and loan holding companies are effectively supervised and can serve as a source of strength for, and do not threaten the soundness of, subsidiary depository institutions.

The CFPB, through rule-making, enforcement and other activities, has the potential to reshape consumer-related laws affecting the Bank. The CFPB's rule-making activities include, among other things, the issuance in January 2013 of final rules implementing Dodd-Frank Act mortgage lending requirements, including the "ability-to-repay" requirement for mortgage lending together with certain safe harbors and rebuttable presumptions of compliance associated with "qualified mortgages."

Congress and federal regulatory agencies continually review banking laws, regulations, and policies for possible changes. Changes to statutes, regulations, or regulatory policies, including changes in interpretation or implementation of statutes, regulations, or policies, could affect us in substantial and unpredictable ways. Such changes could subject us to additional costs, limit the types of financial services and products we may offer, restrict mergers and acquisitions, investments, access to capital, the location of banking offices, or increase the ability of non-banks to offer competing financial services and products, among other things. Failure, or alleged failure, to comply with laws, regulations or policies could result in sanctions by regulatory agencies, civil or criminal penalties or money damages in connection with actions or proceedings on behalf of regulators or consumers, and/or reputational damage, any of which could have a material adverse effect on our business, financial condition and results of operations. While we have policies and procedures designed to prevent any such violations and to reduce the likelihood of such actions or proceedings, there can be no assurance that such violations will not occur or that such actions or proceedings will not be brought.

Changes to laws and regulations, including changes in interpretation or implementation, may also limit the Bank's flexibility on financial products and fees which could result in additional operational costs and a reduction in our non-interest income.

Further, our regulators have significant discretion and authority to prevent or remedy unsafe or unsound practices or violations of laws by financial institutions and holding companies in the performance of their supervisory and enforcement duties. Examples include limits on payment of dividends by banks and regulations governing compensation. Regulation of dividends may limit the liquidity of the Company and limits on compensation may adversely affect our ability to attract and retain employees. See the other risk factors included with the Company's most recently filed Form 10-K for a discussion of risks related to the Company's and the Bank's Supervisory Agreements to which we have become subject, for a discussion regarding the Bank IMCR, and for a discussion of other restrictions to which the Company and the Bank have become subject.

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

None.

Item 3. Defaults Upon Senior Securities.

The Company deferred its February 15, 2011, May 15, 2011, August 15, 2011, November 15, 2011, February 15, 2012, May 15, 2012, August 15, 2012, November 15, 2012, February 15, 2013, May 15, 2013, and August 15, 2013 regular quarterly cash dividend payments on its Preferred Stock. The Company has also determined that it will defer its November 15, 2013 dividend payment and, following that deferral, the Company will have an aggregate arrearage of \$4.2 million with respect to the Preferred Stock. For additional information on these dividend deferrals, please see Part I, Item 2, "Management's Discussion and Analysis Financial Condition and Results of Operations – Liquidity and Capital Resources" of this report on Form 10-Q.

Item 4. Mine Safety Disclosures.

Not applicable.

Item 5. Other Information.

None.

Item 6. Exhibits.

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

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SIGNATURES

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

HMN FINANCIAL, INC.
Registrant

Date: November 6, 2013

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

Date: November 6, 2013

By: /s/ Jon Eberle
Jon Eberle,
Chief Financial Officer and Senior
Vice President
(Principal Financial Officer)

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 |
|--|---|---|---|
| 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 Certifications of CEO and CFO | 32 | Filed Electronically |
| 101 | Financial statements from the Quarterly Report on Form 10-Q of the Company for the period ended September 30, 2013, filed with the SEC on November 6, 2013, formatted in eXtensible Business Reporting Language (XBRL); (i) the Consolidated Balance Sheets at September 30, 2013 and December 31, 2012, (ii) the Consolidated Statements of Comprehensive Income (Loss) for the Three Month and Nine Month Periods Ended September 30, 2013 and 2012, (iii) the Consolidated Statement of Stockholders' Equity for the Nine Month Period Ended September 30, 2013, (iv) the Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2013 and 2012, and (v) Notes to Consolidated Financial Statements. | 101 | Filed Electronically |