

HMN FINANCIAL INC
Form 10-Q
August 04, 2011

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

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

For the quarterly period ended June 30, 2011

OR

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

For the transition period from _____ to _____

**Commission File Number 0-24100
HMN FINANCIAL, INC.**

(Exact name of Registrant as specified in its Charter)

Delaware

41-1777397

(State or other jurisdiction of incorporation or organization)

(I.R.S. Employer Identification Number)

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

55901

(Address of principal executive offices)

(ZIP Code)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

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

Yes No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer
(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 July 22, 2011

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Common stock, \$0.01 par value

4,387,951

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

| (Dollars in thousands) | June 30, 2011 (unaudited) | December 31, 2010 |
|---|---------------------------------|-------------------------|
| Assets | | |
| Cash and cash equivalents | \$ 26,724 | 20,981 |
| Securities available for sale: | | |
| Mortgage-backed and related securities (amortized cost \$25,410 and \$32,036) | 26,780 | 33,506 |
| Other marketable securities (amortized cost \$107,616 and \$118,631) | 107,467 | 118,058 |
| | 134,247 | 151,564 |
| Loans held for sale | 1,075 | 2,728 |
| Loans receivable, net | 601,787 | 664,241 |
| Accrued interest receivable | 2,932 | 3,311 |
| Real estate, net | 21,868 | 16,382 |
| Federal Home Loan Bank stock, at cost | 5,574 | 6,743 |
| Mortgage servicing rights, net | 1,520 | 1,586 |
| Premises and equipment, net | 8,925 | 9,450 |
| Prepaid expenses and other assets | 2,722 | 3,632 |
| Deferred tax asset, net | 0 | 0 |
| Total assets | \$ 807,374 | 880,618 |
| Liabilities and Stockholders Equity | | |
| Deposits | \$ 647,115 | 683,230 |
| Federal Home Loan Bank advances and Federal Reserve borrowings | 85,000 | 122,500 |
| Accrued interest payable | 898 | 1,092 |
| Customer escrows | 730 | 818 |
| Accrued expenses and other liabilities | 6,060 | 3,431 |
| Total liabilities | 739,803 | 811,071 |
| Commitments and contingencies | | |
| Stockholders equity: | | |
| Serial preferred stock (\$.01 par value): | | |
| authorized 500,000 shares; issued shares 26,000 | 24,517 | 24,264 |
| Common stock (\$.01 par value): | | |
| authorized 11,000,000; issued shares 9,128,662 | 91 | 91 |
| Additional paid-in capital | 53,607 | 56,420 |
| Retained earnings, subject to certain restrictions | 53,313 | 55,838 |
| Accumulated other comprehensive income | 865 | 541 |

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|--|------------|----------|
| Unearned employee stock ownership plan shares | (3,287) | (3,384) |
| Treasury stock, at cost 4,740,711 and 4,818,263 shares | (61,535) | (64,223) |
| Total stockholders' equity | 67,571 | 69,547 |
| Total liabilities and stockholders' equity | \$ 807,374 | 880,618 |

See accompanying notes to consolidated financial statements.

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Table of Contents**HMN FINANCIAL, INC. AND SUBSIDIARIES****Consolidated Statements of Loss**

(unaudited)

| <i>(Dollars in thousands, except per share data)</i> | Three Months Ended | | Six Months Ended | |
|--|--------------------|--------|------------------|--------|
| | June 30, | | June 30, | |
| | 2011 | 2010 | 2011 | 2010 |
| Interest income: | | | | |
| Loans receivable | \$ 9,301 | 11,461 | 19,204 | 23,220 |
| Securities available for sale: | | | | |
| Mortgage-backed and related | 290 | 479 | 614 | 1,014 |
| Other marketable | 407 | 591 | 824 | 1,163 |
| Cash equivalents | 2 | 1 | 3 | 2 |
| Other | 45 | 37 | 114 | 74 |
| Total interest income | 10,045 | 12,569 | 20,759 | 25,473 |
| Interest expense: | | | | |
| Deposits | 1,806 | 3,038 | 3,746 | 6,459 |
| Federal Home Loan Bank advances | 1,240 | 1,542 | 2,569 | 3,064 |
| Total interest expense | 3,046 | 4,580 | 6,315 | 9,523 |
| Net interest income | 6,999 | 7,989 | 14,444 | 15,950 |
| Provision for loan losses | 3,463 | 4,360 | 5,409 | 10,893 |
| Net interest income after provision for loan losses | 3,536 | 3,629 | 9,035 | 5,057 |
| Non-interest income: | | | | |
| Fees and service charges | 925 | 920 | 1,849 | 1,762 |
| Mortgage servicing fees | 250 | 274 | 500 | 542 |
| Gains on sales of loans | 301 | 467 | 796 | 781 |
| Other | 113 | 120 | 230 | 270 |
| Total non-interest income | 1,589 | 1,781 | 3,375 | 3,355 |
| Non-interest expense: | | | | |
| Compensation and benefits | 3,512 | 3,411 | 7,072 | 6,860 |
| Loss (gain) on real estate owned | 143 | 33 | 190 | (728) |
| Occupancy | 916 | 1,035 | 1,856 | 2,066 |
| Deposit insurance | 407 | 519 | 811 | 1,036 |
| Data processing | 305 | 298 | 558 | 574 |
| Other | 2,209 | 1,034 | 3,797 | 2,539 |
| Total non-interest expense | 7,492 | 6,330 | 14,284 | 12,347 |

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| | | | | |
|---|------------|---------|---------|----------|
| Loss before income tax expense (benefit) | (2,367) | (920) | (1,874) | (3,935) |
| Income tax expense (benefit) | (76) | 6,912 | 0 | 5,744 |
| Net loss | (2,291) | (7,832) | (1,874) | (9,679) |
| Preferred stock dividends and discount | 457 | 448 | 906 | 888 |
| Net loss available to common shareholders | \$ (2,748) | (8,280) | (2,780) | (10,567) |
| Basic loss per common share | \$ (0.72) | (2.20) | (0.73) | (2.82) |
| Diluted loss per common share | \$ (0.72) | (2.20) | (0.73) | (2.82) |

See accompanying notes to consolidated financial statements.

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Consolidated Statement of Stockholders Equity and Comprehensive Loss
For the Six-Month Period Ended June 30, 2011
(unaudited)

| <i>(Dollars in thousands)</i> | Preferred Stock | Common Stock | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Income | Unearned Employee Stock Ownership Plan Shares | Treasury Stock | Total Stock- Holders Equity |
|---|--------------------|-----------------|----------------------------------|----------------------|---|--|-------------------|--------------------------------------|
| Balance, December 31, 2010 | \$ 24,264 | 91 | 56,420 | 55,838 | 541 | (3,384) | (64,223) | 69,547 |
| Net loss | | | | (1,874) | | | | (1,874) |
| Other comprehensive income, net of tax: | | | | | | | | |
| Net unrealized gains on securities available for sale | | | | | 324 | | | 324 |
| Total comprehensive loss | | | | | | | | (1,550) |
| Preferred stock discount amortization | 253 | | (253) | | | | | 0 |
| Stock compensation tax benefits | | | 14 | | | | | 14 |
| Unearned compensation restricted stock awards | | | (2,700) | | | | 2,700 | 0 |
| Restricted stock awards forfeited | | | 12 | | | | (12) | 0 |
| Amortization of restricted stock awards | | | 152 | | | | | 152 |
| Preferred stock dividends accrued | | | | (651) | | | | (651) |
| Earned employee stock ownership plan shares | | | (38) | | | 97 | | 59 |
| Balance, June 30, 2011 | \$ 24,517 | 91 | 53,607 | 53,313 | 865 | (3,287) | (61,535) | 67,571 |

See accompanying notes to consolidated financial statements.

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

(unaudited)

| | Six Months Ended June 30, | |
|---|------------------------------|------------|
| | 2011 | 2010 |
| <i>(Dollars in thousands)</i> | | |
| Cash flows from operating activities: | | |
| Net loss | \$ (1,874) | (9,679) |
| Adjustments to reconcile net loss to cash provided by operating activities: | | |
| Provision for loan losses | 5,409 | 10,893 |
| Depreciation | 640 | 837 |
| Amortization of premiums, net | 166 | 324 |
| Amortization of deferred loan fees | (294) | (114) |
| Amortization of mortgage servicing rights, net | 213 | 219 |
| Capitalized mortgage servicing rights | (147) | (333) |
| Deferred income tax | 0 | 11,625 |
| Loss (gain) on real estate | 190 | (728) |
| Gains on sales of loans | (796) | (781) |
| Proceeds from sale of loans held for sale | 25,350 | 39,782 |
| Disbursements on loans held for sale | (19,237) | (35,981) |
| Amortization of restricted stock awards | 152 | 190 |
| Amortization of unearned ESOP shares | 97 | 96 |
| Earned employee stock ownership shares priced below original cost | (38) | (19) |
| Stock option compensation | 14 | 31 |
| Decrease (increase) in accrued interest receivable | 379 | (282) |
| Decrease in accrued interest payable | (194) | (660) |
| Decrease (increase) in other assets | 867 | (4,926) |
| Increase (decrease) in accrued expenses and other liabilities | 1,965 | (482) |
| Other, net | 119 | 3 |
| Net cash provided by operating activities | 12,981 | 10,015 |
| Cash flows from investing activities: | | |
| Principal collected on securities available for sale | 6,635 | 9,803 |
| Proceeds collected on maturities of securities available for sale | 80,000 | 63,000 |
| Purchases of securities available for sale | (69,028) | (70,149) |
| Purchase of Federal Home Loan Bank Stock | (17) | (874) |
| Redemption of Federal Home Loan Bank Stock | 1,186 | 971 |
| Proceeds from sales of real estate | 2,463 | 13,616 |
| Net decrease in loans receivable | 45,473 | 32,695 |
| Purchases of premises and equipment | (115) | (64) |
| Net cash provided by investing activities | 66,597 | 48,998 |
| Cash flows from financing activities: | | |
| Decrease in deposits | (36,247) | (49,820) |
| Dividends to preferred stockholders | 0 | (650) |

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| | | |
|--|-----------|----------|
| Proceeds from borrowings | 0 | 5,000 |
| Repayment of borrowings | (37,500) | (5,000) |
| Decrease in customer escrows | (88) | (257) |
| Net cash used by financing activities | (73,835) | (50,727) |
| Increase in cash and cash equivalents | 5,743 | 8,286 |
| Cash and cash equivalents, beginning of period | 20,981 | 16,418 |
| Cash and cash equivalents, end of period | \$ 26,724 | 24,704 |
| Supplemental cash flow disclosures: | | |
| Cash paid for interest | \$ 6,509 | 10,182 |
| Cash paid for income taxes | 0 | 39 |
| Supplemental noncash flow disclosures: | | |
| Transfer of loans to real estate | 8,259 | 8,254 |
| Loans transferred to loans held for sale | 3,607 | 2,899 |
| See accompanying notes to consolidated financial statements. | | |

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HMN FINANCIAL, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
(unaudited)
June 30, 2011 and 2010

(1) HMN Financial, Inc.

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

(2) Basis of Preparation

The accompanying unaudited consolidated financial statements were prepared in accordance with instructions for Form 10-Q and therefore, do not include all disclosures necessary for a complete presentation of the consolidated balance sheets, consolidated statements of loss, consolidated statement of stockholders' equity and comprehensive loss 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 six-month period ended June 30, 2011 is not necessarily indicative of the results which may be expected for the entire year. Certain amounts in the consolidated financial statements for prior periods have been reclassified to conform with the current period presentation.

(3) New Accounting Standards

In July 2010, the FASB issued ASU 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*, which requires significant new disclosures about the allowance for credit losses and the credit quality of financing receivables. The requirements are intended to enhance transparency regarding credit losses and the credit quality of loan and lease receivables. Under this statement, allowance for credit losses and fair value are to be disclosed by portfolio segment, while credit quality information, impaired financing receivables and nonaccrual status are to be presented by class of financing receivable. Disclosure of the nature and extent, the financial impact and segment information of troubled debt restructurings are also required. The disclosures are to be presented at the level of disaggregation that management uses when assessing and monitoring the portfolio's risk and performance. This ASU is effective for interim and annual reporting periods after December 15, 2010 and the related disclosures were included in Note 5 in the Company's December 31, 2010 notes to the consolidated financial statements and in Note 9 of this quarterly report.

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

In April 2011, the FASB issued ASU 2011-02, *Receivables (Topic 310), A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring*. This ASU provides guidance on evaluating whether a restructuring constitutes a troubled debt restructuring. It indicates that if a creditor separately concludes that a restructuring constitutes a concession and that the debtor is experiencing financial difficulties that the restructuring is a troubled debt restructuring. It also clarifies guidance on a creditor's evaluation of the above two items. For public entities, such as HMN, the amendments in this ASU are effective for the first interim or annual period beginning on or after June 15, 2011, and should be applied retrospectively to the beginning of the annual period of adoption. In addition, this ASU requires that the disclosures about troubled debt restructurings that

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were delayed by ASU 2011-01 in January 2011 be disclosed for interim and annual periods beginning on or after June 15, 2011. It is anticipated the implementation of the guidance in this ASU will result in more loan restructurings being classified as troubled debt restructurings and will require additional disclosure when adopted in the third quarter of 2011.

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

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

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

(4) Derivative Instruments and Hedging Activities

The Company has commitments outstanding to extend credit to future borrowers that have not closed prior to the end of the quarter. The Company intends to sell these commitments, which are referred to as its mortgage pipeline. As commitments to originate loans enter the mortgage pipeline, the Company generally enters into commitments to sell the mortgage pipeline into the secondary market on a firm commitment or best efforts basis. The commitments to originate, purchase or sell loans on a firm commitment basis are derivatives. As a result of marking to market the mortgage pipeline and the related firm commitments to sell for the period ended June 30, 2011, the Company recorded an increase in other assets of \$10,000, an increase in other liabilities of \$14,000 and a loss included in the gain on sales of loans of \$4,000.

The current commitments to sell loans held for sale are derivatives that do not qualify for hedge accounting. As a result, these derivatives are marked to market and the related loans held for sale are recorded at the lower of cost or market. The Company recorded a decrease in other assets of \$53,000 and an increase in the mark to market adjustment for loans held for sale of \$53,000.

(5) Fair Value Measurements

ASC 820, *Fair Value Measurements* establishes a framework for measuring the fair value of assets and liabilities using a hierarchy system consisting of three levels, based on the markets in which the assets and liabilities are

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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 June 30, 2011 and December 31, 2010.

| <i>(Dollars in thousands)</i> | Carrying value at June 30, 2011 | | | |
|-------------------------------|---------------------------------|---------|---------|---------|
| | Total | Level 1 | Level 2 | Level 3 |
| Securities available for sale | \$ 134,247 | 1,146 | 133,101 | 0 |
| Mortgage loan commitments | 10 | 0 | 10 | 0 |
| Total | \$ 134,257 | 1,146 | 133,111 | 0 |

| <i>(Dollars in thousands)</i> | Carrying value at December 31, 2010 | | | |
|-------------------------------|-------------------------------------|---------|---------|---------|
| | Total | Level 1 | Level 2 | Level 3 |
| Securities available for sale | \$ 151,564 | 1,740 | 149,824 | 0 |
| Mortgage loan commitments | (1) | 0 | (1) | 0 |
| Total | \$ 151,563 | 1,740 | 149,823 | 0 |

There were no transfers between Levels 1, 2, or 3 during the three or six month periods ended June 30, 2011.

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 second quarter of 2011 that were still held at June 30, 2011, 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 June 30, 2011 and December 31, 2010

| <i>(Dollars in thousands)</i> | Carrying value at June 30, 2011 | | | | | Three months ended | | Six months ended | |
|---------------------------------|---------------------------------|-------|---------|---------|----------------------|--------------------|----------------------|------------------|--|
| | Total | Level | | Level 3 | Total gains (losses) | June 30, 2011 | Total gains (losses) | June 30, 2011 | |
| | | 1 | Level 2 | | | | | | |
| Loans held for sale | \$ 1,075 | 0 | 1,075 | 0 | 3 | | 53 | | |
| Mortgage servicing rights | 1,520 | 0 | 1,520 | 0 | 0 | | 0 | | |
| Loans ⁽¹⁾ | 56,697 | 0 | 56,697 | 0 | (3,248) | | (5,330) | | |
| Real estate, net ⁽²⁾ | 21,868 | 0 | 21,868 | 0 | (54) | | (134) | | |

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| | | | | | | |
|-------|-----------|---|--------|---|---------|---------|
| Total | \$ 81,160 | 0 | 81,160 | 0 | (3,299) | (5,411) |
|-------|-----------|---|--------|---|---------|---------|

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| <i>(Dollars in thousands)</i> | Carrying value at December 31, 2010 | | | | Year ended December 31, 2010 |
|---------------------------------|-------------------------------------|------------|---------------|------------|------------------------------------|
| | Total | Level 1 | Level 2 | Level 3 | Total Losses |
| Loans held for sale | \$ 2,728 | 0 | 2,728 | 0 | (6) |
| Mortgage servicing rights | 1,586 | 0 | 1,586 | 0 | 0 |
| Loans ⁽¹⁾ | 43,039 | 0 | 43,039 | 0 | (18,855) |
| Real estate, net ⁽²⁾ | 16,382 | 0 | 16,382 | 0 | (1,782) |
| Total | \$ 63,735 | 0 | 63,735 | 0 | (20,643) |

(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 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 June 30, 2011 and December 31, 2010 are shown below.

| <i>(Dollars in thousands)</i> | June 30, 2011 | | | December 31, 2010 | | |
|---|--------------------|-------------------------|--------------------|--------------------|-------------------------|--------------------|
| | Carrying amount | Estimated fair value | Contract amount | Carrying amount | Estimated fair value | Contract amount |
| Financial assets: | | | | | | |
| Cash and cash equivalents | \$ 26,724 | 26,724 | | 20,981 | 20,981 | |
| Securities available for sale | 134,247 | 134,247 | | 151,564 | 151,564 | |
| Loans held for sale | 1,075 | 1,075 | | 2,728 | 2,728 | |
| Loans receivable, net | 601,787 | 598,597 | | 664,241 | 655,508 | |
| Federal Home Loan Bank stock | 5,574 | 5,574 | | 6,743 | 6,743 | |
| Accrued interest receivable | 2,932 | 2,932 | | 3,311 | 3,311 | |
| Financial liabilities: | | | | | | |
| Deposits | 647,115 | 647,115 | | 683,230 | 683,230 | |
| Federal Home Loan Bank advances | 85,000 | 90,546 | | 122,500 | 129,893 | |
| Accrued interest payable | 898 | 898 | | 1,092 | 1,092 | |
| Off-balance sheet financial instruments: | | | | | | |

| | | | | | | |
|------------------------------|----|----|--------|-----|-----|--------|
| Commitments to extend credit | 10 | 10 | 94,313 | 56 | 56 | 92,313 |
| Commitments to sell loans | 12 | 12 | 3,066 | (1) | (1) | 3,413 |

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

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| <i>(Dollars in thousands)</i> | For the three months ended June 30, | | | | | |
|--|-------------------------------------|------------|------------|------------|------------|------------|
| | 2011 | | | 2010 | | |
| | Before tax | Tax effect | Net of tax | Before tax | Tax effect | Net of tax |
| Securities available for sale: | | | | | | |
| Net unrealized gains arising during the period | \$ 514 | 76 | 438 | 289 | 115 | 174 |
| Other comprehensive income | \$ 514 | 76 | 438 | 289 | 115 | 174 |

| <i>(Dollars in thousands)</i> | For the six months ended June 30, | | | | | |
|---|-----------------------------------|------------|------------|------------|------------|------------|
| | 2011 | | | 2010 | | |
| | Before tax | Tax effect | Net of tax | Before tax | Tax effect | Net of tax |
| Securities available for sale: | | | | | | |
| Net unrealized gains (losses) arising during the period | \$ 324 | 0 | 324 | (88) | (35) | (53) |
| Other comprehensive income (loss) | \$ 324 | 0 | 324 | (88) | (35) | (53) |

(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 June 30, 2011 and December 31, 2010.

| <i>(Dollars in thousands)</i> | June 30, 2011 | | | | | | | | |
|---------------------------------------|-------------------------|------------|-------------------|-----------------------|------------|-------------------|------------|-------------------|--|
| | Less than twelve months | | | Twelve months or more | | | Total | | |
| | # of Investments | Fair Value | Unrealized Losses | # of Investments | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | |
| Other marketable securities: | | | | | | | | | |
| Corporate preferred stock | 0 | \$ 0 | 0 | 1 | \$ 175 | (525) | \$ 175 | (525) | |
| Total temporarily impaired securities | 0 | \$ 0 | 0 | 1 | \$ 175 | (525) | \$ 175 | (525) | |

| <i>(Dollars in thousands)</i> | December 31, 2010 | | | | | | | | |
|-------------------------------|-------------------------|------------|-------------------|-----------------------|------------|-------------------|------------|-------------------|--|
| | Less than twelve months | | | Twelve months or more | | | Total | | |
| | # of Investments | Fair Value | Unrealized Losses | # of Investments | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | |

| | | | | | | | | |
|---------------------------------------|----|-----------|-------|---|--------|-------|-----------|-------|
| Other marketable securities: | | | | | | | | |
| U.S. Government agency obligations | 10 | \$ 47,610 | (266) | 0 | \$ 0 | 0 | \$ 47,610 | (266) |
| Corporate preferred stock | 0 | 0 | 0 | 1 | 175 | (525) | 175 | (525) |
| Total temporarily impaired Securities | 10 | \$ 47,610 | (266) | 1 | \$ 175 | (525) | \$ 47,785 | (791) |

We review our investment portfolio on a quarterly basis for indications of impairment. This review includes 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 June 30, 2011 related to a single trust preferred security that was issued by the holding company of a small community bank. Typical of most trust preferred issuances, the issuer has the ability to defer interest payments for up to five years with interest payable on the deferred balance. In October 2009, the issuer elected to defer its scheduled interest payments as allowed by the terms of the security agreement. The issuer's subsidiary bank has incurred operating losses due to increased provisions for loan losses but still meets the regulatory requirements to be considered adequately capitalized based on its most recent regulatory filing. Based on information furnished by the issuer, it is anticipated that the entity will improve its capital position and be well capitalized after a branch sale is completed, for which a sale agreement has been signed. In addition, the

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owners of the issuing bank appear to have the ability to make additional capital contributions, if needed, to enhance the bank's capital position. Based on a review of the issuer, it was determined that the trust preferred security was not other-than-temporarily impaired at June 30, 2011. The Company does not intend to sell the preferred stock and has the intent and ability to hold it for a period of time sufficient to recover the temporary loss. Management believes that the Company will receive all principal and interest payments contractually due on the security and that the decrease in the market value is primarily due to a lack of liquidity in the market for trust preferred securities and the deferral of interest by the issuer. Management will continue to monitor the credit risk of the issuer and may be required to recognize other-than-temporary impairment charges on this security in future periods.

A summary of securities available for sale at June 30, 2011 and December 31, 2010 is as follows:

| <i>(Dollars in thousands)</i> | Amortized cost | Gross unrealized gains | Gross unrealized losses | Fair value |
|--------------------------------------|-------------------|------------------------------|-------------------------------|---------------|
| June 30, 2011: | | | | |
| Mortgage-backed securities: | | | | |
| FHLMC | \$ 14,274 | 705 | 0 | 14,979 |
| FNMA | 10,023 | 632 | 0 | 10,655 |
| Collateralized mortgage obligations: | | | | |
| FHLMC | 732 | 25 | 0 | 757 |
| FNMA | 381 | 8 | 0 | 389 |
| | 25,410 | 1,370 | 0 | 26,780 |
| Other marketable securities: | | | | |
| U.S. Government agency obligations | 106,916 | 376 | 0 | 107,292 |
| Corporate preferred stock | 700 | 0 | (525) | 175 |
| | 107,616 | 376 | (525) | 107,467 |
| | \$ 133,026 | 1,746 | (525) | 134,247 |

| <i>(Dollars in thousands)</i> | Amortized cost | Gross unrealized gains | Gross unrealized losses | Fair value |
|--------------------------------------|-------------------|------------------------------|-------------------------------|---------------|
| December 31, 2010: | | | | |
| Mortgage-backed securities: | | | | |
| FHLMC | \$ 17,555 | 719 | 0 | 18,274 |
| FNMA | 12,800 | 692 | 0 | 13,492 |
| Collateralized mortgage obligations: | | | | |
| FHLMC | 1,299 | 44 | 0 | 1,343 |
| FNMA | 382 | 15 | 0 | 397 |
| | 32,036 | 1,470 | 0 | 33,506 |

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Other marketable securities:

| | | | | |
|------------------------------------|------------|-------|-------|---------|
| U.S. Government agency obligations | 117,931 | 218 | (266) | 117,883 |
| Corporate preferred stock | 700 | 0 | (525) | 175 |
| | 118,631 | 218 | (791) | 118,058 |
| | \$ 150,667 | 1,688 | (791) | 151,564 |

The following table indicates amortized cost and estimated fair value of securities available for sale at June 30, 2011 based upon contractual maturity adjusted for scheduled repayments of principal and projected repayments of principal based upon current economic conditions and interest rates.

| <i>(Dollars in thousands)</i> | Amortized cost | Fair Value |
|--|-------------------|---------------|
| Due less than one year | \$ 107,426 | 108,247 |
| Due after one year through five years | 23,477 | 24,325 |
| Due after five years through ten years | 1,423 | 1,500 |
| Due after ten years | 700 | 175 |
| Total | \$ 133,026 | 134,247 |

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The allocation of mortgage-backed securities and collateralized mortgage obligations in the table above is based upon the anticipated future cash flow of the securities using estimated mortgage prepayment speeds.

(9) Allowance for Loan Losses and Credit Quality Information

The allowance for loan losses is summarized as follows:

| <i>(Dollars in thousands)</i> | 1-4 Family | Commercial Real Estate | Consumer | Commercial Business | Total |
|--|---------------|---------------------------|----------|------------------------|----------|
| For the three months ended June 30, 2011: | | | | | |
| Balance, March 31, 2011 | \$ 2,498 | 17,558 | 1,023 | 13,874 | 34,953 |
| Provision for losses | 954 | 2,376 | 159 | (26) | 3,463 |
| Charge-offs | (15) | (4,633) | (35) | (6,249) | (10,932) |
| Recoveries | 0 | 66 | 7 | 207 | 280 |
| Balance, June 30, 2011 | \$ 3,437 | 15,367 | 1,154 | 7,806 | 27,764 |
| For the six months ended June 30, 2011: | | | | | |
| Balance, December 31, 2010 | 2,145 | 24,590 | 924 | 15,169 | 42,828 |
| Provision for losses | 1,710 | 2,914 | 307 | 478 | 5,409 |
| Charge-offs | (418) | (12,209) | (87) | (8,557) | (21,271) |
| Recoveries | 0 | 72 | 10 | 716 | 798 |
| Balance, June 30, 2011 | \$ 3,437 | 15,367 | 1,154 | 7,806 | 27,764 |
| Allocated to: | | | | | |
| Specific reserves | \$ 993 | 13,263 | 76 | 10,702 | 25,034 |
| General reserves | 1,152 | 11,327 | 848 | 4,467 | 17,794 |
| Balance, December 31, 2010 | \$ 2,145 | 24,590 | 924 | 15,169 | 42,828 |
| Allocated to: | | | | | |
| Specific reserves | \$ 1,430 | 6,354 | 293 | 4,070 | 12,147 |
| General reserves | 2,007 | 9,013 | 861 | 3,736 | 15,617 |
| Balance, June 30, 2011 | \$ 3,437 | 15,367 | 1,154 | 7,806 | 27,764 |
| Loans receivable at December 31, 2010: | | | | | |
| Individually reviewed for impairment | \$ 6,729 | 45,077 | 299 | 26,855 | 78,960 |
| Collectively reviewed for impairment | 121,806 | 311,314 | 70,304 | 126,184 | 629,608 |

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| | | | | | |
|--------------------------------------|------------|---------|--------|---------|---------|
| Ending balance | \$ 128,535 | 356,391 | 70,603 | 153,039 | 708,568 |
| Loans receivable at June 30, 2011: | | | | | |
| Individually reviewed for impairment | \$ 4,653 | 34,260 | 664 | 17,120 | 56,697 |
| Collectively reviewed for impairment | 118,010 | 279,457 | 66,003 | 110,461 | 573,931 |
| Ending balance | \$ 122,663 | 313,717 | 66,667 | 127,581 | 630,628 |

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The following table summarizes the amount of classified and unclassified loans at June 30, 2011 and December 31, 2010:

| <i>(Dollars in thousands)</i> | June 30, 2011 | | | | | | Total Loans |
|-------------------------------|--------------------|-------------|----------|------|---------|-----------------------|----------------|
| | Special Mention | Classified | | | Total | Unclassified Total | |
| | | Substandard | Doubtful | Loss | | | |
| 1-4 family | \$ 8,385 | 5,105 | 359 | 250 | 14,099 | 108,564 | 122,663 |
| Commercial real estate: | | | | | | | |
| Residential developments | 8,851 | 25,778 | 0 | 0 | 34,629 | 33,901 | 68,530 |
| Alternative fuels | 5,769 | 2,266 | 0 | 0 | 8,035 | 18,096 | 26,131 |
| Other | 5,784 | 7,534 | 0 | 0 | 13,318 | 205,738 | 219,056 |
| Consumer | 0 | 334 | 181 | 149 | 664 | 66,003 | 66,667 |
| Commercial business: | | | | | | | |
| Construction/development | 0 | 3,046 | 0 | 0 | 3,046 | 2,976 | 6,022 |
| Banking | 0 | 675 | 1,299 | 0 | 1,974 | 5,580 | 7,554 |
| Other | 4,034 | 12,565 | 0 | 0 | 16,599 | 97,406 | 114,005 |
| | \$ 32,823 | 57,303 | 1,839 | 399 | 92,364 | 538,264 | 630,628 |
| <i>(Dollars in thousands)</i> | December 31, 2010 | | | | | | Total Loans |
| | Special Mention | Classified | | | Total | Unclassified Total | |
| | | Substandard | Doubtful | Loss | | | |
| 1-4 family | \$ 7,395 | 8,228 | 0 | 0 | 15,623 | 112,912 | 128,535 |
| Commercial real estate: | | | | | | | |
| Residential developments | 8,373 | 34,515 | 0 | 0 | 42,888 | 44,218 | 87,106 |
| Alternative fuels | 0 | 11,069 | 0 | 0 | 11,069 | 20,054 | 31,123 |
| Other | 6,268 | 6,614 | 0 | 0 | 12,882 | 225,280 | 238,162 |
| Consumer | 0 | 248 | 31 | 27 | 306 | 70,297 | 70,603 |
| Commercial business: | | | | | | | |
| Construction/development | 1,776 | 4,907 | 0 | 0 | 6,683 | 5,117 | 11,800 |
| Banking | 0 | 4,975 | 3,248 | 0 | 8,223 | 5,830 | 14,053 |
| Other | 4,712 | 15,689 | 67 | 0 | 20,468 | 106,718 | 127,186 |
| | \$ 28,524 | 86,245 | 3,346 | 27 | 118,142 | 590,426 | 708,568 |

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

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The aging of past due loans at June 30, 2011 and December 31, 2010 is summarized as follows:

| | 30-59 | 60-89 | 90 Days | Total | Current | Total | Loans 90 |
|-------------------------------|----------|-------|---------|--------|---------|---------|-----------|
| | Days | Days | or More | Past | Loans | Loans | Days or |
| <i>(Dollars in thousands)</i> | Past | Past | Past | Past | | | More Past |
| | Due | Due | Due | Due | | | Due and |
| | | | | | | | Still |
| | | | | | | | Accruing |
| <i>June 30, 2011</i> | | | | | | | |
| 1-4 family | \$ 2,485 | 1,341 | 453 | 4,279 | 118,384 | 122,663 | 0 |
| Commercial real estate: | | | | | | | |
| Residential developments | 1,709 | 5,441 | 0 | 7,150 | 61,380 | 68,530 | 0 |
| Alternative fuels | 0 | 0 | 2,266 | 2,266 | 23,865 | 26,131 | 0 |
| Other | 1,291 | 0 | 0 | 1,291 | 217,765 | 219,056 | 0 |
| Consumer | 527 | 7 | 466 | 1,000 | 65,667 | 66,667 | 0 |
| Commercial business: | | | | | | | |
| Construction/development | 0 | 0 | 0 | 0 | 6,022 | 6,022 | 0 |
| Banking | 0 | 0 | 1,974 | 1,974 | 5,580 | 7,554 | 0 |
| Other | 586 | 2,786 | 5,558 | 8,930 | 105,075 | 114,005 | 0 |
| | \$ 6,598 | 9,575 | 10,717 | 26,890 | 603,738 | 630,628 | 0 |
| <i>December 31, 2010</i> | | | | | | | |
| 1-4 family | \$ 2,313 | 695 | 3,500 | 6,508 | 122,027 | 128,535 | 178 |
| Commercial real estate: | | | | | | | |
| Residential developments | 444 | 3,899 | 15,523 | 19,866 | 67,240 | 87,106 | 0 |
| Alternative fuels | 0 | 0 | 4,994 | 4,994 | 26,129 | 31,123 | 0 |
| Other | 75 | 264 | 3,914 | 4,253 | 233,909 | 238,162 | 0 |
| Consumer | 446 | 163 | 207 | 816 | 69,787 | 70,603 | 0 |
| Commercial business: | | | | | | | |
| Construction/development | 0 | 0 | 4,809 | 4,809 | 6,991 | 11,800 | 0 |
| Banking | 0 | 0 | 8,223 | 8,223 | 5,830 | 14,053 | 0 |
| Other | 311 | 45 | 7,876 | 8,232 | 118,954 | 127,186 | 576 |
| | \$ 3,589 | 5,066 | 49,046 | 57,701 | 650,867 | 708,568 | 754 |

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Impaired loans include loans that are non-performing (non-accruing) and loans that have been modified in a troubled debt restructuring. The following table summarizes impaired loans and related allowances as of June 30, 2011 and December 31, 2010:

| <i>(Dollars in thousands)</i> | June 30, 2011 | | | December 31, 2010 | | |
|---|---------------------|--------------------------|-------------------|---------------------|--------------------------|-------------------|
| | Recorded Investment | Unpaid Principal Balance | Related Allowance | Recorded Investment | Unpaid Principal Balance | Related Allowance |
| Loans with no related allowance recorded: | | | | | | |
| 1-4 family | \$ 1,336 | 1,336 | 0 | 932 | 932 | 0 |
| Commercial real estate: | | | | | | |
| Residential developments | 5,716 | 5,716 | 0 | 6,486 | 6,486 | 0 |
| Alternative fuels | 2,266 | 4,994 | 0 | 0 | 0 | 0 |
| Other | 657 | 657 | 0 | 119 | 119 | 0 |
| Consumer | 224 | 224 | 0 | 104 | 104 | 0 |
| Commercial business: | | | | | | |
| Construction/development | 344 | 1,462 | 0 | 99 | 99 | 0 |
| Banking | 1,974 | 8,223 | 0 | 0 | 0 | 0 |
| Other | 665 | 865 | 0 | 397 | 397 | 0 |
| Loans with an allowance recorded: | | | | | | |
| 1-4 family | 3,317 | 3,317 | 1,430 | 5,797 | 5,797 | 994 |
| Commercial real estate: | | | | | | |
| Residential developments | 18,756 | 18,756 | 4,887 | 27,147 | 27,147 | 9,673 |
| Alternative fuels | 0 | 0 | 0 | 4,994 | 4,994 | 2,441 |
| Other | 6,865 | 8,821 | 1,467 | 6,331 | 7,287 | 1,148 |
| Consumer | 440 | 440 | 293 | 195 | 195 | 76 |
| Commercial business: | | | | | | |
| Construction/development | 2,702 | 2,849 | 530 | 4,809 | 4,809 | 2,668 |
| Banking | 0 | 0 | 0 | 8,223 | 8,223 | 4,985 |
| Other | 11,435 | 11,987 | 3,540 | 13,327 | 13,878 | 3,049 |
| Total: | | | | | | |
| 1-4 family | 4,653 | 4,653 | 1,430 | 6,729 | 6,729 | 994 |
| Commercial real estate: | | | | | | |
| Residential developments | 24,472 | 24,472 | 4,887 | 33,633 | 33,633 | 9,673 |
| Alternative fuels | 2,266 | 4,994 | 0 | 4,994 | 4,994 | 2,441 |
| Other | 7,522 | 9,478 | 1,467 | 6,450 | 7,406 | 1,148 |
| Consumer | 664 | 664 | 293 | 299 | 299 | 76 |
| Commercial business: | | | | | | |
| Construction/development | 3,046 | 4,311 | 530 | 4,908 | 4,908 | 2,668 |
| Banking | 1,974 | 8,223 | 0 | 8,223 | 8,223 | 4,985 |
| Other | 12,100 | 12,852 | 3,540 | 13,724 | 14,275 | 3,049 |
| | \$ 56,697 | 69,647 | 12,147 | 78,960 | 80,467 | 25,034 |

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| <i>(Dollars in thousands)</i> | For the three months ended June 30, 2011 | | For the six months ended June 30, 2011 | |
|---|---|----------------------------------|---|----------------------------------|
| | Average Recorded Investment | Interest Income Recognized | Average Recorded Investment | Interest Income Recognized |
| Loans with no related allowance recorded: | | | | |
| 1-4 family | \$ 1,354 | 16 | 1,213 | 36 |
| Commercial real estate: | | | | |
| Residential developments | 5,798 | 14 | 6,027 | 88 |
| Alternative fuels | 1,133 | 0 | 755 | 0 |
| Other | 656 | 10 | 477 | 13 |
| Consumer | 132 | 0 | 123 | 2 |
| Commercial business: | | | | |
| Construction/development | 345 | 2 | 263 | 4 |
| Banking | 987 | 0 | 658 | 0 |
| Other | 654 | 3 | 568 | 17 |
| Loans with an allowance recorded: | | | | |
| 1-4 family | 4,029 | 50 | 4,618 | 86 |
| Commercial real estate: | | | | |
| Residential developments | 15,826 | 192 | 19,599 | 431 |
| Alternative fuels | 2,498 | 0 | 3,330 | 0 |
| Other | 6,406 | 40 | 6,381 | 59 |
| Consumer | 347 | 5 | 296 | 10 |
| Commercial business: | | | | |
| Construction/development | 3,344 | 18 | 3,831 | 36 |
| Banking | 4,112 | 0 | 5,482 | 0 |
| Other | 11,366 | 63 | 12,020 | 147 |
| Total: | | | | |
| 1-4 family | 5,383 | 66 | 5,831 | 122 |
| Commercial real estate: | | | | |
| Residential developments | 21,624 | 206 | 25,626 | 519 |
| Alternative fuels | 3,631 | 0 | 4,085 | 0 |
| Other | 7,062 | 50 | 6,858 | 72 |
| Consumer | 479 | 5 | 419 | 12 |
| Commercial business: | | | | |
| Construction/development | 3,689 | 20 | 4,094 | 40 |
| Banking | 5,099 | 0 | 6,140 | 0 |
| Other | 12,020 | 66 | 12,588 | 164 |
| | \$ 58,987 | 413 | 65,641 | 929 |

At June 30, 2011 and December 31, 2010, non-accruing loans totaled \$43.1 million and \$68.1 million, respectively, for which the related allowance for loan losses was \$10.2 million and \$25.0 million, respectively. Interest is subsequently recognized as income to the extent cash is received when, in management's judgment, principal is

collectible. 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 \$11.3 million and \$8.1 million, respectively. Non-accrual loans also include certain loans that have had terms modified in a troubled debt restructuring.

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The non-accrual loans at June 30, 2011 and December 31, 2010 are summarized as follows:

| <i>(Dollars in thousands)</i> | June 30, 2011 | December 31, 2010 |
|-------------------------------|------------------|----------------------|
| 1-4 family | \$ 2,039 | \$ 4,844 |
| Commercial real estate: | | |
| Residential developments | 16,422 | 25,980 |
| Alternative fuels | 2,266 | 4,994 |
| Other | 6,506 | 5,763 |
| Consumer | 555 | 224 |
| Commercial business: | | |
| Construction/development | 3,046 | 4,907 |
| Banking | 1,974 | 8,223 |
| Other | 10,278 | 13,139 |
| | \$ 43,086 | \$ 68,074 |

At June 30, 2011 and December 31, 2010 there were loans included in loans receivable, net, with terms that had been modified in a troubled debt restructuring totaling \$28.1 million and \$19.3 million, respectively. For the loans that were restructured in the second quarter of 2011, \$1.0 million were classified but performing and \$6.3 million were non-performing at June 30, 2011.

The following table summarizes troubled debt restructurings at June 30, 2011 and December 31, 2010:

| <i>(Dollars in thousands)</i> | June 30, 2011 | December 31, 2010 |
|-------------------------------|------------------|----------------------|
| Commercial real estate | \$ 20,275 | 14,871 |
| Commercial business | 4,119 | 1,756 |
| 1-4 family | 3,534 | 2,589 |
| Consumer | 200 | 75 |
| | \$ 28,128 | 19,291 |

There were no material commitments to lend additional funds to customers whose loans were restructured or classified as nonaccrual at June 30, 2011 or December 31, 2010.

(10) Investment in Mortgage Servicing Rights

A summary of mortgage servicing activity is as follows:

| <i>(Dollars in thousands)</i> | Six Months ended June 30, 2011 | Twelve Months ended December 31, 2010 | Six Months ended June 30, 2010 |
|---|--------------------------------------|--|--------------------------------------|
| Mortgage servicing rights: | | | |
| Balance, beginning of period | \$ 1,586 | 1,315 | 1,315 |
| Originations | 147 | 753 | 333 |
| Amortization | (213) | (482) | (219) |
| Balance, end of period | \$ 1,520 | 1,586 | 1,429 |
| Fair value of mortgage servicing rights | \$ 2,297 | 2,263 | 2,331 |

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. Loans are sold under general representations and warranties and based on insignificant requests for repurchase, a liability has not been recorded for repurchase requests from FNMA. The following is a summary of the risk characteristics of the loans being serviced at June 30, 2011.

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| | Loan Principal | Weighted Average Interest Rate | Weighted Average Remaining Term | Number of Loans |
|----------------------------------|-------------------|--------------------------------------|--|--------------------|
| <i>(Dollars in thousands)</i> | Balance | | | |
| Original term 30 year fixed rate | \$ 218,415 | 5.20% | 299 | 1,879 |
| Original term 15 year fixed rate | 97,291 | 4.63% | 123 | 1,445 |
| Adjustable rate | 693 | 3.13% | 269 | 9 |

The gross carrying amount of mortgage servicing rights and the associated accumulated amortization at June 30, 2011 is presented in the table below.

| | Gross Carrying Amount | Accumulated Amortization | Unamortized Intangible Assets |
|-------------------------------|-----------------------------|-----------------------------|-------------------------------------|
| <i>(Dollars in thousands)</i> | | | |
| Mortgage servicing rights | \$ 4,067 | (2,547) | 1,520 |
| Total | \$ 4,067 | (2,547) | 1,520 |

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

| | Mortgage Servicing Rights |
|-------------------------------|---------------------------------|
| <i>(Dollars in thousands)</i> | |
| Year ended December 31, | |
| 2011 | \$ 180 |
| 2012 | 330 |
| 2013 | 312 |
| 2014 | 282 |
| 2015 | 236 |
| Thereafter | 180 |

Projections of amortization are based on existing asset balances and the existing interest rate environment as of June 30, 2011. The Company's actual experiences may be significantly different depending upon changes in mortgage interest rates and other market conditions.

(11) Loss per Common Share

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|--------------------------------|-------|------------------------------|-------|
| | 2011 | 2010 | 2011 | 2010 |
| <i>(Dollars in thousands, except per share data)</i> | | | | |
| Weighted average number of common shares outstanding used in basic loss per common share calculation | 3,841 | 3,757 | 3,829 | 3,747 |
| Net dilutive effect of: | | | | |
| Options | 0 | 0 | 0 | 0 |
| Restricted stock awards | 0 | 0 | 0 | 0 |
| Weighted average number of shares outstanding adjusted for effect of dilutive securities | 3,841 | 3,757 | 3,829 | 3,747 |

| | | | | |
|---------------------------------------|------------|---------|---------|----------|
| Loss available to common shareholders | \$ (2,748) | (8,280) | (2,780) | (10,567) |
| Basic loss per common share | \$ (0.72) | (2.20) | (0.73) | (2.82) |
| Diluted loss per common share | \$ (0.72) | (2.20) | (0.73) | (2.82) |

At June 30, 2011 and June 30, 2010, there were 127,351 and 240,807 common share equivalents outstanding, respectively, that are not included in the calculation of diluted earnings per share as they are anti-dilutive.

(12) Regulatory Capital and Regulatory Oversight

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material adverse 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.

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Quantitative measures established by regulations to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the following table) of Tier I or core capital and risk-based capital (as defined in the regulations) to total assets (as defined). Management believes, as of June 30, 2011, that the Bank meets all capital adequacy requirements to which it is subject.

Management believes that based upon the Bank's capital calculations at June 30, 2011 and other conditions consistent with the Prompt Corrective Actions Provisions of the OTS regulations, the Bank would be categorized as well capitalized.

The Bank's tangible assets and adjusted total assets were \$805.8 million and \$879.5 million and its risk-weighted assets were \$622.1 million and \$687.7 million at June 30, 2011 and December 31, 2010, respectively. The following table presents the Bank's capital amounts and ratios at June 30, 2011 and December 31, 2010 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 | |
|---|-----------|----------------------------------|---------------------------------------|----------------------------------|----------------|----------------------------------|---|----------------------------------|
| | Amount | Percent of Assets ⁽¹⁾ | Amount | Percent of Assets ⁽¹⁾ | Amount | Percent of Assets ⁽¹⁾ | Amount | Percent of Assets ⁽¹⁾ |
| <i>(Dollars in thousands)</i> | | | | | | | | |
| June 30, 2011 | | | | | | | | |
| Bank stockholder's equity | \$ 67,070 | | | | | | | |
| Less: | | | | | | | | |
| Net unrealized gains on certain securities Available for sale | (1,533) | | | | | | | |
| | 65,537 | | | | | | | |
| Tier I or core capital | | | | | | | | |
| Tier I capital to adjusted total assets | | 8.13% | \$ 32,232 | 4.00% | \$ 33,305 | 4.13% | \$ 40,290 | 5.00% |
| Tier I capital to risk-weighted assets | | 10.53% | \$ 24,886 | 4.00% | \$ 40,651 | 6.53% | \$ 37,329 | 6.00% |
| Plus: | | | | | | | | |
| Allowable allowance for loan losses | 7,777 | | | | | | | |
| Risk-based capital | \$ 73,314 | | \$ 49,771 | | \$ 23,543 | | \$ 62,214 | |
| Risk-based capital to risk-weighted assets | | 11.78% | | 8.00% | | 3.78% | | 10.00% |

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

Required to be

| | Actual | | Adequately Capitalized | | Excess Capital | | To Be Well Capitalized Under Prompt Corrective Actions Provisions | |
|---|-----------|----------------------------------|------------------------|----------------------------------|----------------|----------------------------------|---|----------------------------------|
| | Amount | Percent of Assets ⁽¹⁾ | Amount | Percent of Assets ⁽¹⁾ | Amount | Percent of Assets ⁽¹⁾ | Amount | Percent of Assets ⁽¹⁾ |
| <i>(Dollars in thousands)</i> | | | | | | | | |
| December 31, 2010 | | | | | | | | |
| Bank stockholder s equity | \$ 68,034 | | | | | | | |
| Less: | | | | | | | | |
| Net unrealized gains on certain securities Available for sale | (1,210) | | | | | | | |
| | 66,824 | | | | | | | |
| Tier I or core capital | | | | | | | | |
| Tier I capital to adjusted total assets | | 7.60% | \$ 35,181 | 4.00% | \$ 31,643 | 3.60% | \$ 43,977 | 5.00% |
| Tier I capital to risk-weighted assets | | 9.72% | \$ 27,507 | 4.00% | \$ 39,317 | 5.72% | \$ 41,261 | 6.00% |
| Plus: | | | | | | | | |
| Allowable allowance for loan losses | 8,596 | | | | | | | |
| Risk-based capital | \$ 75,420 | | \$ 55,014 | | \$ 20,406 | | \$ 68,768 | |
| Risk-based capital to risk-weighted assets | | 10.97% | | 8.00% | | 2.97% | | 10.00% |

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

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The Bank entered into a written Supervisory Agreement with its primary federal banking regulator, the Office of Thrift Supervision (OTS), effective February 22, 2011 that primarily relates to the Bank's financial performance and credit quality issues. This agreement replaced the prior memorandum of understanding that the Bank entered into with the OTS on December 9, 2009. In accordance with the Supervisory Agreement, the Bank submitted a two year business plan that the OTS may make comments upon, and require revisions to. The Bank must operate within the parameters of the final business plan and is required to monitor and submit periodic reports on its compliance with the plan. The Bank also submitted a problem asset reduction plan that the OTS may make comments upon, and require revisions to. The Bank must operate within the parameters of the final problem asset plan and is required to monitor and submit periodic reports on its compliance with the plan. The Bank has also revised its loan modification policies and its program for identifying, monitoring and controlling risk associated with concentrations of credit, and improved the documentation relating to the allowance for loan and lease losses as required by the agreement. In addition, without the consent of the OCC (as successor to the OTS), the Bank may not declare or pay any cash dividends, materially increase the total assets of the Bank, enter into any new contractual arrangement or renew or extend any existing arrangement related to compensation or benefits with any directors or officer, make any golden parachute payments, or enter into any significant contracts with a third party service provider.

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

The OTS proposed to the Bank as its Individual Minimum Capital Requirement (IMCR) a tier 1 capital to adjusted total assets requirement of 8.5% commencing September 30, 2011, which is in excess of the Bank's tier 1 capital to adjusted total assets ratio at June 30, 2011. An IMCR requires a bank to establish and maintain levels of capital greater than those required for banks generally to be classified as well-capitalized. The Bank has submitted proposed modifications to the proposed IMCR and had discussions with the OTS (predecessor to the OCC, the Bank's current primary banking regulator) related to the timing for implementation of the proposed IMCR. However, at the time of filing of this Quarterly Report on Form 10-Q, no IMCR has been imposed on the Bank.

References to the OTS shall mean, with respect to the Company, beginning July 21, 2011, the Federal Reserve Board (FRB) and mean, with respect to the Bank, beginning July 21, 2011, the Office of the Comptroller of the Currency (OCC). On July 21, 2011 the OTS was integrated into the OCC and the primary banking regulator for the Company became the FRB. It is not anticipated that the change in primary regulators as a result of the OTS being abolished will have any significant impact on the Company, the Bank, or our shareholders.

(13) Commitments and Contingencies

The Bank issued standby letters of credit which guarantee the performance of customers to third parties. The standby letters of credit issued and available at June 30, 2011 were approximately \$1.6 million, expire over the next two years, and are collateralized primarily with commercial real estate mortgages. Since the conditions under which the Bank is required to fund the standby letters of credit may not materialize, the cash requirements are expected to be less than the total outstanding commitments.

(14) Business Segments

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

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

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The following table sets forth certain information about the 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 six months ended June 30, 2011: | | | | |
| Interest income external customers | \$ 20,759 | 0 | 0 | 20,759 |
| Non-interest income external customers | 3,380 | 0 | 0 | 3,380 |
| Loss on limited partnerships | (5) | 0 | 0 | (5) |
| Intersegment interest income | 0 | 2 | (2) | 0 |
| Intersegment non-interest income | 87 | (1,292) | 1,205 | 0 |
| Interest expense | 6,317 | 0 | (2) | 6,315 |
| Amortization of mortgage servicing rights, net | 213 | 0 | 0 | 213 |
| Other non-interest expense | 13,569 | 589 | (87) | 14,071 |
| Income tax expense (benefit) | 0 | 0 | 0 | 0 |
| Net loss | (1,288) | (1,878) | 1,292 | (1,874) |
| Total assets | 807,307 | 68,934 | (68,867) | 807,374 |
| At or for the six months ended June 30, 2010: | | | | |
| Interest income external customers | \$ 25,473 | 0 | 0 | 25,473 |
| Non-interest income external customers | 3,370 | 0 | 0 | 3,370 |
| Loss on limited partnerships | (15) | 0 | 0 | (15) |
| Intersegment interest income | 0 | 2 | (2) | 0 |
| Intersegment non-interest income | 87 | (9,111) | 9,024 | 0 |
| Interest expense | 9,525 | 0 | (2) | 9,523 |
| Amortization of mortgage servicing rights, net | 219 | 0 | 0 | 219 |
| Other non-interest expense | 11,812 | 403 | (87) | 12,128 |
| Income tax expense | 5,573 | 171 | 0 | 5,744 |
| Net loss | (9,107) | (9,683) | 9,111 | (9,679) |
| Total assets | 974,247 | 90,402 | (89,406) | 975,243 |
| At or for the quarter ended June 30, 2011: | | | | |
| Interest income external customers | \$ 10,045 | 0 | 0 | 10,045 |
| Non-interest income external customers | 1,592 | 0 | 0 | 1,592 |
| Loss on limited partnerships | (3) | 0 | 0 | (3) |
| Intersegment interest income | 0 | 1 | (1) | 0 |
| Intersegment non-interest income | 44 | (1,980) | 1,936 | 0 |
| Interest expense | 3,047 | 0 | (1) | 3,046 |
| Amortization of mortgage servicing rights, net | 115 | 0 | 0 | 115 |
| Other non-interest expense | 7,106 | 315 | (44) | 7,377 |

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| | | | | |
|--------------------|---------|---------|----------|---------|
| Income tax benefit | (76) | 0 | 0 | (76) |
| Net loss | (1,978) | (2,293) | 1,980 | (2,291) |
| Total assets | 807,307 | 68,934 | (68,867) | 807,374 |

At or for the quarter ended June 30, 2010:

| | | | | |
|---|-----------|---------|----------|---------|
| Interest income external customers | \$ 12,569 | 0 | 0 | 12,569 |
| Non-interest income external customers | 1,788 | 0 | 0 | 1,788 |
| Loss on limited partnerships | (7) | 0 | 0 | (7) |
| Intersegment interest income | 0 | 1 | (1) | 0 |
| Intersegment non-interest income | 44 | (7,439) | 7,395 | 0 |
| Interest expense | 4,581 | 0 | (1) | 4,580 |
| Amortization of mortgage servicing rights, net | 110 | 0 | 0 | 110 |
| Other non-interest expense | 6,064 | 200 | (44) | 6,220 |
| Income tax expense | 6,716 | 196 | 0 | 6,912 |
| Net loss | (7,437) | (7,834) | 7,439 | (7,832) |
| Total assets | 974,247 | 90,402 | (89,406) | 975,243 |

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**HMN FINANCIAL, INC.
MANAGEMENT'S DISCUSSION AND ANALYSIS
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

Forward-looking Information

This Quarterly Report, other reports filed by the Company with the Securities and Exchange Commission may contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements are often identified by such forward-looking terminology as expect, intent, look, believe, anticipate, estimate, project, seek, may, will, would, could, should, trend, target, and goal or similar statements. Such terms and include, but are not limited to, those relating to the adequacy and amount of available liquidity and capital resources to the Bank, the Company's liquidity and capital requirements, changes in the size of the Bank's loan portfolio, the recovery of the valuation allowance on deferred tax assets, the amount and mix of the Bank's non-performing assets and the appropriateness of the allowance therefore, future losses on non-performing assets, the amount of interest-earning assets, the amount and mix of brokered and other deposits (including the Company's ability to renew brokered deposits), the availability of alternate funding sources, the payment of dividends, the future outlook for the Company, the amount of deposits that will be withdrawn from checking and money market accounts and how the withdrawn deposits will be replaced, the projected changes in net interest income based on rate shocks, the range that interest rates may fluctuate over the next twelve months, the net market risk of interest rate shocks and the Company's, the future outlook for the issuer trust preferred securities held by the Bank, expectations relating to the change in Company and Bank primary banking regulators from the OTS to the OCC and FRB, the uncertainty regarding amount and timing of any final IMCR which may be imposed upon the Bank, and the Bank's compliance with regulatory standards generally (including the Bank's status as well-capitalized), and supervisory agreements, individual minimum capital requirements or other supervisory directives or requirements to which the Company or the Bank are or may become expressly subject, specifically. A number of factors could cause actual results to differ materially from the Company's assumptions and expectations. These include but are not limited to the adequacy and marketability of real estate securing loans to borrowers, possible legislative and regulatory changes, including changes in the degree and manner of regulatory supervision, the ability of the Company and the Bank to establish and adhere to plans and policies relating to, among other things, capital, business, non-performing assets, loan modifications, documentation of loan loss allowance and concentrations of credit that are satisfactory to the OCC and FRB, as applicable, in accordance with the terms of the Company and Bank supervisory agreements and to otherwise manage the operations of the Company and the Bank to ensure compliance with other requirements set forth in the supervisory agreements; the ability of the Company and the Bank to obtain required consents from the OCC and FRB, as applicable, under the supervisory agreements or other directives; the amount and timing of any individual minimum capital requirement which may be imposed on the Bank; adverse economic, business and competitive developments such as shrinking interest margins; reduced collateral values; deposit outflows; reduced demand for financial services and loan products; changes in accounting policies and guidelines, or monetary and fiscal policies of the federal government or tax laws; international economic developments, changes in credit or other risks posed by the Company's loan and investment portfolios; technological, computer-related or operational difficulties; adverse changes in securities markets; results of litigation; collateral advance rates and policies of the FHLB; costs associated with alternate funding sources; or other significant uncertainties. Additional factors that may cause actual results to differ from the Company's assumptions and expectations include those set forth in the Company's most recent filings on Form 10-K and Quarterly Reports on Form 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, 2010 and Part II, Item 1A of this Quarterly Report on Form 10-Q. 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, Federal Home Loan Bank (FHLB) advances, and Federal Reserve Bank (FRB) borrowings. The difference between the average rate of interest earned on assets and the average rate paid on liabilities is the interest rate spread. Net interest income is produced when interest-earning assets equal or exceed interest-bearing liabilities and there is a positive interest rate spread. Net interest income and net interest rate spread are affected by changes in interest rates, the volume and mix of interest-earning assets and interest-bearing liabilities,

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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. Since a commercial lending program was established in 1998, the Company has increased its emphasis on commercial and commercial real estate loans, which has increased the credit risk inherent in the loan portfolio. While HMN did not originate or hold subprime mortgages in its loan portfolio, purchase investments backed by subprime mortgages, or incur any write downs directly related to subprime mortgages, subprime credit issues indirectly impacted the Company by making it more difficult for some borrowers with marginal credit to qualify for a mortgage because most of the non-traditional mortgage products were eliminated by the banks and mortgage companies that were previously offering them. This decrease in available credit reduced the demand for single family homes as there were fewer qualified buyers in the marketplace. The decrease in demand for housing and building lots affected our level of loan charge offs and the risk ratings on many of our residential development loans. Consequently, our provision for loan losses significantly increased relative to periods before the current economic slowdown. The increase in the provision was due primarily to commercial loan charge offs and risk rating downgrades caused by continued weak demand for housing and building and general economic weakness in our markets. In addition, our losses on loans and other real estate owned increased due to the declining value of the real estate.

The earnings of financial institutions, such as the Bank, are significantly affected by prevailing economic and competitive conditions, particularly changes in interest rates, government monetary and fiscal policies, and regulations of various regulatory authorities. Lending activities are influenced by the demand for and supply of 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 levels of personal income and savings.

Critical Accounting Policies

Critical accounting policies are those policies that the Company's management believes are the most important to understanding the Company's financial condition and operating results. The Company has identified the following policies as being critical because they require difficult, subjective, and/or complex judgments that are inherently uncertain. Therefore, actual financial results could differ significantly depending upon the estimates, assumptions and other factors used.

Allowance for Loan Losses and Related Provision

The allowance for loan losses is based on periodic analysis of the loan portfolio. In this analysis, management considers factors including, but not limited to, specific occurrences of loan impairment, changes in the size of the portfolios, national and regional economic conditions such as unemployment data, loan portfolio composition, loan delinquencies, local construction permits, development plans, local economic growth rates, historical experience and observations made by the Company's ongoing internal audit and regulatory exam processes. Loans are charged off to the extent they are deemed to be uncollectible. The Company has established separate components of its overall methodology to determine the 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 specific reserves. 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

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the periods in which the adjustments become known. Because of the size of some loans, changes in estimates can have a significant impact on the loan loss provision. The allowance is allocated to individual loan categories based upon the relative risk characteristics of the loan portfolios and the actual loss experience. The Company increases its allowance for loan losses by charging the provision for loan losses against income. The methodology for establishing the allowance for loan losses takes into consideration probable losses that have been identified in connection with specific loans as well as probable losses in the loan portfolio for which 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 and certain specific reserves are deductible, not the entire provision for loan losses. Under generally accepted accounting principles, a valuation allowance is required to be recognized if it is more likely than not that the deferred tax asset will not be realized. The determination of the realizability of the deferred tax assets is highly subjective and dependent upon management's judgment and evaluation of both positive and negative evidence, including the forecasts of future income, tax planning strategies and assessments of the current and future economic and business conditions. The Company considers both positive and negative evidence regarding the ultimate realizability of deferred tax assets. Positive evidence includes the ability to implement tax planning strategies to accelerate taxable income recognition and the probability that taxable income will be generated in future periods. Negative evidence includes the Company's cumulative loss in the prior three year period, current financial performance, and the general business and economic trends. At June 30, 2011, the Company recorded a valuation allowance against the entire deferred tax asset balance. This determination was based primarily upon the existence of a three year cumulative loss position that is primarily attributable to significant provisions for loan losses incurred during the last three years. The creation of the valuation allowance, although it increased tax expense and similarly reduced tangible book value, does not have an effect on the Company's cash flows, and may be recoverable in subsequent periods if the Company were to realize certain sustained future taxable income. It is possible that future conditions may differ substantially from those anticipated in determining the need for a valuation allowance on deferred tax assets and adjustments may be required in the future.

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

RESULTS OF OPERATIONS FOR SECOND QUARTER ENDED JUNE 30, 2011 COMPARED TO SECOND QUARTER ENDED JUNE 30, 2010*Net Loss*

Net loss for the second quarter of 2011 was \$2.3 million, an improvement of \$5.5 million, or 70.7%, compared to a net loss of \$7.8 million for the second quarter of 2010. Net loss available to common shareholders was \$2.7 million for the second quarter of 2011, an improvement of \$5.6 million, or 66.8%, from the net loss available to common shareholders of \$8.3 million for the second quarter of 2010. Diluted loss per common share for the

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second quarter of 2011 was \$0.72, an improvement of \$1.48, or 67.3%, from the diluted loss per common share of \$2.20 for the second quarter of 2010. The decrease in the net loss for the quarter was due primarily to a \$7.0 million decrease in the provision for income taxes between the periods due primarily to a deferred tax asset valuation reserve that was established during the second quarter of 2010. The decrease in the net loss was also due to a \$0.9 million decrease in the loan loss provision between the periods. These decreases in expense were partially offset by a \$1.0 million decrease in net interest income due primarily to a decrease in interest earning assets that was partially offset by an increase in the net interest margin between the periods and a \$1.2 million increase in expenses related to other real estate owned.

Net loss was \$1.9 million for the six month period ended June 30, 2011, an improvement of \$7.8 million, or 80.6%, compared to the net loss of \$9.7 million for the six month period ended June 30, 2010. The net loss available to common shareholders was \$2.8 million for the six month period ended June 30, 2011, an improvement of \$7.8 million, or 73.7%, compared to the net loss available to common shareholders of \$10.6 million for the same period of 2010. Diluted loss per share for the six month period in 2011 was \$0.73, an improvement of \$2.09 compared to the diluted loss per share of \$2.82 for the same period in 2010. The decrease in the net loss for the six month period in 2011 was due to a \$5.7 million decrease in the provision for income taxes between the periods due primarily to a deferred tax asset valuation reserve that was established during the second quarter of 2010 and also because of a \$5.5 million decrease in the loan loss provision between the periods. These decreases in expense were partially offset by a \$1.6 million decrease in net interest income due primarily to the decrease in interest earning assets between the periods and a \$2.2 million increase in other expenses and losses related to other real estate owned.

Net Interest Income

Net interest income was \$7.0 million for the second quarter of 2011, a decrease of \$1.0 million, or 12.4%, compared to \$8.0 million for the second quarter of 2010. Interest income was \$10.0 million for the second quarter of 2011, a decrease of \$2.6 million, or 20.1%, from \$12.6 million for the same period in 2010. Interest income decreased between the periods primarily because of a \$147 million decrease in the average interest-earning assets and also because of a decrease in average yields between the periods. Average interest earning assets decreased between the periods primarily because of a decrease in the commercial loan portfolio, which occurred because of declining loan demand and the Company's focus on improving credit quality, managing net interest margin and improving capital ratios. The average yield earned on interest-earning assets was 5.00% for the second quarter of 2011, a decrease of 29 basis points from the 5.29% average yield for the second quarter of 2010. The decrease in the yield on interest-earning assets is due to the continued low interest rate environment that existed during the second quarter of 2011.

Interest expense was \$3.0 million for the second quarter of 2011, a decrease of \$1.6 million, or 33.5%, compared to \$4.6 million for the second quarter of 2010. Interest expense decreased primarily because of the \$130 million decrease in the average interest-bearing liabilities between the periods. The decrease in average interest-bearing liabilities is primarily the result of a decrease in the outstanding borrowings and brokered certificates of deposits between the periods. The decrease in borrowings and brokered deposits between the periods was the result of using the proceeds from loan principal payments to fund maturing borrowings and brokered certificates of deposits. Interest expense also decreased because of the lower interest rates paid on money market accounts and certificates of deposits. The decreased rates were the result of the low interest rate environment that continued to exist during the second quarter of 2011. The average interest rate paid on interest-bearing liabilities was 1.58% for the second quarter of 2011, a decrease of 45 basis points from the 2.03% average interest rate paid in the second quarter of 2010.

Net interest margin (net interest income divided by average interest earning assets) for the second quarter of 2011 was 3.48%, an increase of 11 basis points, compared to 3.37% for the second quarter of 2010.

Net interest income was \$14.4 million for the first six months of 2011, a decrease of \$1.6 million, or 9.4%, from \$16.0 million for the same period in 2010. Interest income was \$20.8 million for the six month period ended June 30, 2011, a decrease of \$4.7 million, or 18.5%, from \$25.5 million for the same six month period in 2010. Interest income decreased between the periods primarily because of a \$145 million decrease in the average interest-earning assets and also because of a decrease in average yields between the periods. Average interest-earning assets decreased between the periods primarily because of a decrease in the commercial loan portfolio,

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which occurred because of declining loan demand and the Company's focus on improving credit quality, managing net interest margin and improving capital ratios. The average yield earned on interest-earning assets was 5.11% for the first six months of 2011, a decrease of 22 basis points from the 5.33% average yield for the first six months of 2010. The decrease in the yield on interest-earning assets is due to the continued low interest rate environment that existed during the first six months of 2011.

Interest expense was \$6.3 million for the first six months of 2011, a decrease of \$3.2 million, or 33.7%, compared to \$9.5 million for the first six months of 2010. Interest expense decreased primarily because of the \$127 million decrease in the average interest-bearing liabilities between the periods. The decrease in average interest-bearing liabilities is primarily the result of a decrease in the outstanding borrowings and brokered certificates of deposits between the periods. The decrease in borrowings and brokered deposits between the periods was the result of using the proceeds from loan principal payments to fund maturing borrowings and brokered certificates of deposits. Interest expense also decreased because of the lower interest rates paid on money market accounts and certificates of deposits. The decreased rates were the result of the low interest rate environment that continued to exist during the first six months of 2011. The average interest rate paid on interest-bearing liabilities was 1.62% for the first six months of 2011, a decrease of 48 basis points from the 2.10% average interest rate paid in the first six months of 2010.

Net interest margin (net interest income divided by average interest earning assets) for the first six months of 2011 was 3.55%, an increase of 21 basis points, compared to 3.34% for the first six months of 2010.

A summary of the Company's net interest margin for the three and six month periods ended June 30, 2011 and June 30, 2010 is as follows:

| | For the three month period ended | | | | | |
|---|-----------------------------------|-----------------------------|----------------|-----------------------------------|-----------------------------|----------------|
| | June 30, 2011 | | | June 30, 2010 | | |
| <i>(Dollars in thousands)</i> | Average Outstanding Balance | Interest Earned/ Paid | Yield/ Rate | Average Outstanding Balance | Interest Earned/ Paid | Yield/ Rate |
| Interest-earning assets: | | | | | | |
| Securities available for sale | \$ 153,600 | 697 | 1.82% | \$ 165,887 | 1,070 | 2.59% |
| Loans held for sale | 1,689 | 18 | 4.27 | 2,946 | 37 | 5.04 |
| Mortgage loans, net | 123,550 | 1,693 | 5.50 | 139,117 | 1,948 | 5.62 |
| Commercial loans, net | 422,720 | 6,593 | 6.26 | 540,498 | 7,987 | 5.93 |
| Consumer loans, net | 66,725 | 997 | 5.99 | 77,121 | 1,489 | 7.74 |
| Cash equivalents | 31,220 | 1 | 0.01 | 19,225 | 1 | 0.02 |
| Federal Home Loan Bank stock | 6,174 | 46 | 2.99 | 7,428 | 37 | 2.00 |
| Total interest-earning assets | 805,678 | 10,045 | 5.00 | 952,222 | 12,569 | 5.29 |
| Interest-bearing liabilities: | | | | | | |
| NOW accounts | 70,287 | 14 | 0.08 | 103,052 | 30 | 0.12 |
| Savings accounts | 37,455 | 14 | 0.15 | 33,017 | 11 | 0.13 |
| Money market accounts | 113,928 | 205 | 0.72 | 143,394 | 371 | 1.04 |
| Certificates | 253,241 | 983 | 1.56 | 242,611 | 1,439 | 2.38 |
| Brokered deposits | 95,329 | 590 | 2.48 | 163,235 | 1,187 | 2.92 |
| Advances and other borrowings | 110,390 | 1,240 | 4.51 | 135,478 | 1,542 | 4.57 |
| Total interest-bearing liabilities | 680,630 | | | 820,787 | | |

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| | | | | | | |
|--|------------|----------|-------|------------|----------|-------|
| Non-interest checking | 92,553 | | | 81,440 | | |
| Other non-interest bearing deposits | 976 | | | 1,492 | | |
| Total interest-bearing liabilities and non-interest bearing deposits | \$ 774,159 | 3,046 | 1.58 | \$ 903,719 | 4,580 | 2.03 |
| Net interest income | | \$ 6,999 | | | \$ 7,989 | |
| Net interest rate spread | | | 3.42% | | | 3.26% |
| Net interest margin | | | 3.48% | | | 3.37% |

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| | For the six month period ended | | | | | |
|---|--------------------------------|-----------------------|--------------|-----------------------------|-----------------------|--------------|
| | June 30, 2011 | | | June 30, 2010 | | |
| <i>(Dollars in thousands)</i> | Average Outstanding Balance | Interest Earned/ Paid | Yield/ Rate | Average Outstanding Balance | Interest Earned/ Paid | Yield/ Rate |
| Interest-earning assets: | | | | | | |
| Securities available for sale | \$ 151,774 | 1,438 | 1.91% | \$ 162,840 | 2,177 | 2.70% |
| Loans held for sale | 1,614 | 35 | 4.37 | 2,369 | 58 | 4.94 |
| Mortgage loans, net | 125,915 | 3,456 | 5.53 | 141,380 | 4,045 | 5.77 |
| Commercial loans, net | 438,121 | 13,688 | 6.30 | 552,345 | 16,441 | 6.00 |
| Consumer loans, net | 67,690 | 2,025 | 6.03 | 79,045 | 2,676 | 6.83 |
| Cash equivalents | 27,851 | 3 | 0.02 | 18,910 | 2 | 0.02 |
| Federal Home Loan Bank stock | 6,432 | 114 | 3.57 | 7,357 | 74 | 2.03 |
| Total interest-earning assets | 819,397 | 20,759 | 5.11 | 964,246 | 25,473 | 5.33 |
| Interest-bearing liabilities: | | | | | | |
| NOW accounts | 74,628 | 34 | 0.09 | 100,775 | 52 | 0.10 |
| Savings accounts | 36,073 | 27 | 0.15 | 32,422 | 22 | 0.14 |
| Money market accounts | 113,821 | 418 | 0.74 | 140,115 | 762 | 1.10 |
| Certificates | 253,692 | 2,040 | 1.62 | 242,894 | 2,915 | 2.42 |
| Brokered deposits | 98,050 | 1,227 | 2.52 | 181,147 | 2,708 | 3.01 |
| Advances and other borrowings | 115,085 | 2,569 | 4.50 | 134,052 | 3,064 | 4.61 |
| Total interest-bearing liabilities | 691,349 | | | 831,405 | | |
| Non-interest checking | 94,339 | | | 80,544 | | |
| Other non-interest bearing deposits | 1,070 | | | 1,663 | | |
| Total interest-bearing liabilities and non-interest bearing deposits | \$ 786,758 | 6,315 | 1.62 | \$ 913,612 | 9,523 | 2.10 |
| Net interest income | | \$ 14,444 | | | \$ 15,950 | |
| Net interest rate spread | | | 3.49% | | | 3.23% |
| Net interest margin | | | 3.55% | | | 3.34% |

Provision for Loan Losses

The provision for loan losses is recorded to bring the allowance for loan losses to a level deemed appropriate by management based on factors disclosed in the critical accounting policies previously discussed. The provision for loan losses was \$3.5 million for the second quarter of 2011, a decrease of \$0.9 million, or 20.6%, from \$4.4 million for the second quarter of 2010. The decrease in the loan loss provision was primarily the result of stabilizing values of the real estate collateral supporting commercial real estate loans classified as non-performing, which resulted in fewer

write downs in the second quarter of 2011 compared to the same period in 2010.

The provision for loan losses was \$5.4 million for the first six months of 2011, a decrease of \$5.5 million, or 50.3%, from \$10.9 million for the same six month period in 2010. The decrease was primarily the result of the stabilizing values of the real estate collateral supporting commercial real estate loans, which resulted in fewer write downs on loans classified as non-performing in the first six months of 2011 compared to the same period in 2010.

A reconciliation of the Company's allowance for loan losses for the three and six month periods ended June 30, 2011 and June 30, 2010 is summarized as follows:

| <i>(Dollars in thousands)</i> | 2011 | 2010 |
|-------------------------------|-----------|-----------|
| Balance at March 31, | \$ 34,953 | \$ 29,284 |
| Provision | 3,463 | 4,360 |
| Charge offs: | | |
| One-to-four family | (16) | (117) |
| Consumer | (34) | (84) |
| Commercial business | (6,249) | (4,681) |
| Commercial real estate | (4,633) | (2,818) |
| Recoveries | 280 | 83 |
| Balance at June 30, | \$ 27,764 | \$ 26,027 |
| General allowance | \$ 15,644 | \$ 11,104 |
| Specific allowance | 12,120 | 14,923 |
| | \$ 27,764 | \$ 26,027 |

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| <i>(Dollars in thousands)</i> | 2011 | 2010 |
|-------------------------------|-----------|-----------|
| Balance at January 1, | \$ 42,828 | \$ 23,811 |
| Provision | 5,409 | 10,893 |
| Charge offs: | | |
| One-to-four family | (419) | (168) |
| Consumer | (86) | (390) |
| Commercial business | (8,557) | (4,742) |
| Commercial real estate | (12,209) | (3,478) |
| Recoveries | 798 | 101 |
| Balance at June 30, | \$ 27,764 | \$ 26,027 |

Non-Interest Income

Non-interest income was \$1.6 million for the second quarter of 2011, a decrease of \$0.2 million, or 10.8%, from \$1.8 million for the same period in 2010. Gains on sales of loans decreased \$166,000 between the periods as a result of decreased single family loan originations. Loan servicing fees decreased \$24,000 between the periods primarily because of a decrease in the number of commercial loans that are being serviced for others.

Non-interest income was \$3.4 million for the first six months of 2011, the same as for the first six months of 2010. Fees and service charges increased \$87,000 between the periods primarily because of an increase in debit card income and overdraft fees. Gains on sales of loans increased \$15,000 between the periods due to an increase in the gains recognized on the sale of commercial government guaranteed loans that was partially offset by a decrease in the gain recognized on the sale of single family loans due to a decrease in single family loan originations between the periods. Loan servicing fees decreased \$42,000 between the periods primarily because of a decrease in the number of commercial loans that are being serviced for others. Other non-interest income decreased \$40,000 primarily because of a decrease in rental income on real estate owned.

Non-Interest Expense

Non-interest expense was \$7.5 million for the second quarter of 2011, an increase of \$1.2 million, or 18.4%, from \$6.3 million for the same period of 2010. Other non-interest expense increased \$1.2 million primarily because of increased real estate taxes and legal fees related to other real estate owned and \$110,000 because of an increase in the losses recognized on the sale of real estate owned between the periods. Compensation and benefits increased \$101,000 between the periods primarily because of increased personnel in the commercial loan recovery area. Occupancy expense decreased \$119,000 between the periods primarily because of a decrease in depreciation expense. Deposit insurance costs decreased \$112,000 primarily because of a decrease in brokered deposits between the periods.

Non-interest expense was \$14.3 million for the first six months of 2011, an increase of \$2.0 million, or 15.7%, from \$12.3 million for the same period of 2010. Non-interest expense increased \$918,000 because of a \$190,000 loss recognized on real estate owned in the first six months of 2011 compared to a \$728,000 gain recognized on real estate owned in the first six months of 2010. Other non-interest expense increased \$1.3 million because of increased real estate taxes and legal fees related to other real estate owned. Compensation and benefits increased \$212,000 between the periods primarily because of increased personnel in the commercial loan recovery area. Deposit insurance costs decreased \$225,000 between the periods primarily because of a decrease in brokered deposits. Occupancy expense decreased \$210,000 between the periods primarily because of a decrease in depreciation expense.

Income Taxes

The effect of income taxes changed \$7.0 million between the periods, from an expense of \$6.9 million in the second quarter of 2010 to a benefit of \$0.1 million in the second quarter of 2011. In the second quarter of 2010, income taxes were increased \$8.5 million as a result of recording a deferred tax asset valuation reserve, which was partially offset by a \$1.2 million tax benefit recorded as a result of a favorable Minnesota Supreme Court tax ruling during that quarter. The Company continues to maintain a valuation reserve against the entire deferred tax asset balance at

June 30, 2011. Since the valuation reserve is established against the entire deferred tax asset balance, the only amount included as income tax benefit for the second quarter of 2011 relates to the reversal of taxes on the change in the fair market value of the available for sale investment portfolio that was recorded in the first quarter of 2011.

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Income tax expense was \$0 for the first six months of 2011, a decrease of \$5.7 million from \$5.7 million for the same period of 2010. In the second quarter of 2010, income taxes were increased \$8.5 million as a result of recording a deferred tax asset valuation reserve, which was partially offset by a \$1.2 million tax benefit recorded as a result of a favorable Minnesota Supreme Court tax ruling during that quarter. The Company continues to maintain a valuation reserve against the entire deferred tax asset balance at June 30, 2011. Since the valuation reserve is established against the entire deferred tax asset balance, no income tax expense or benefit was recorded for the first six months of 2011 and the taxes on the change in the fair market value of the available for sale investment portfolio are recorded as an adjustment to other comprehensive income.

Net Loss Available to Common Shareholders

The net loss available to common shareholders was \$2.7 million for the second quarter of 2011, a decreased loss of \$5.6 million from the \$8.3 million net loss available to common shareholders in the second quarter of 2010. The net loss available to common shareholders was \$2.8 million for the first six months of 2011, a decreased loss of \$7.8 million from the \$10.6 million net loss available to common shareholders in the first six months of 2010. The net loss available to common shareholders decreased for both the second quarter of 2011 and the six month period ending June 30, 2011 primarily because of the change in the net loss between the periods.

The Company deferred the February 15, 2011 and May 15, 2011 cash dividend payments and has determined that it will defer the August 15, 2011 dividend payment on its Fixed Rate Cumulative Perpetual Preferred Stock, Series A issued to the United States Treasury Department as part of the TARP Capital Purchase Program. The deferred dividend payments have been accrued for payment in the future and are being reported for the deferral period as a preferred dividend requirement that is deducted from income (loss) available to common shareholders for financial statement purposes.

FINANCIAL CONDITION**Non-Performing Assets**

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

| <i>(Dollars in thousands)</i> | June 30, 2011 | March 31, 2011 | December 31, 2010 |
|---------------------------------------|------------------|-------------------|-------------------------|
| Non-Accruing Loans: | | | |
| One-to-four family real estate | \$ 2,039 | \$ 3,399 | \$ 4,844 |
| Commercial real estate | 25,194 | 21,609 | 36,737 |
| Consumer | 555 | 245 | 224 |
| Commercial business | 15,298 | 23,829 | 26,269 |
| Total | 43,086 | 49,082 | 68,074 |
| Other assets | | | |
| Foreclosed and Repossessed Assets: | | | |
| One-to-four family real estate | 2,468 | 1,640 | 972 |
| Consumer | 3 | 14 | 14 |
| Commercial real estate | 19,400 | 19,829 | 15,409 |
| Total non-performing assets | \$ 64,957 | \$ 70,565 | \$ 84,469 |
| Total as a percentage of total assets | 8.05% | 8.03% | 9.59% |

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| | | | |
|--|-----------|-----------|-----------|
| Total non-performing loans | \$ 43,086 | \$ 49,082 | \$ 68,074 |
| Total as a percentage of total loans receivable, net | 7.16% | 7.74% | 10.25% |
| Allowance for loan loss to non-performing loans | 64.44% | 71.21% | 62.91% |
| Delinquency Data: | | | |
| Delinquencies ⁽¹⁾ | | | |
| 30+ days | \$ 8,861 | \$ 4,940 | \$ 4,021 |
| 90+ days | 0 | 178 | 754 |
| Delinquencies as a percentage of loan and lease portfolio ⁽¹⁾ | | | |
| 30+ days | 1.43% | 0.76% | 0.59% |
| 90+ days | 0.00% | 0.03% | 0.11% |

(1) Excludes non-accrual loans.

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The increase in loans that were more than 30 days delinquent at June 30, 2011 relates primarily to two land loans totaling \$2.1 million, four single family loans totaling \$0.9 million, and two commercial loans totaling \$0.8 million that were delinquent more than 30 days at June 30, 2011.

Total non-performing assets were \$65.0 million at June 30, 2011, a decrease of \$5.6 million, or 7.9%, from \$70.6 million at March 31, 2011. Non-performing loans decreased \$6.0 million and foreclosed and repossessed assets increased \$0.4 million during the second quarter of 2011. 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 | |
|----------------------------------|-----------|--|-----------|
| March 31, 2011 | \$ 49,082 | March 31, 2011 | \$ 21,483 |
| | 9,168 | Transferred from non-performing loans | 2,000 |
| Classified as non-performing | | Other foreclosures/repossessions | 27 |
| Charge offs | (10,932) | Real estate sold | (1,417) |
| Principal payments received | (1,207) | Net loss on sale of assets | (87) |
| Classified as accruing | (1,025) | Write downs and payments | (135) |
| Transferred to real estate owned | (2,000) | | |
| June 30, 2011 | \$ 43,086 | June 30, 2011 | \$ 21,871 |

The decrease in non-performing loans during the quarter relates primarily to loans that were charged off during the period. Of the \$10.9 million in charge offs recorded during the second quarter of 2011, \$6.2 million related to two bank stock loans, \$2.7 million was on an alternative fuel plant and \$1.9 million related to two development loans. Of the \$9.2 million in loans classified as non-performing during the second quarter of 2011, \$3.7 million related to two development loans and \$4.3 million related to a land loan that was classified as non-performing during the quarter. The largest remaining non-performing loan at June 30, 2011 was for \$3.7 million and is secured by a residential development located in the Bank's primary market.

Total non-performing assets were \$65.0 million at June 30, 2011, a decrease of \$19.5 million, or 23.1%, from \$84.5 million at December 31, 2010. Non-performing loans decreased \$25.0 million and foreclosed and repossessed assets increased \$5.5 million during the first six months of 2011. The non-performing loan and foreclosed and repossessed asset activity for the first six months of 2011 was as follows:

(Dollars in thousands)

| Non-performing loans | | Foreclosed and repossessed assets | |
|----------------------------------|-----------|--|-----------|
| January 1, 2011 | \$ 68,074 | January 1, 2011 | \$ 16,395 |
| | 11,641 | Transferred from non-performing loans | 8,231 |
| Classified as non-performing | | Other foreclosures/repossessions | 28 |
| Charge offs | (21,271) | Real estate sold | (2,472) |
| Principal payments received | (2,146) | Net loss on sale of assets | (6) |
| Classified as accruing | (4,953) | Write downs and payments | (305) |
| Transferred to real estate owned | (8,259) | | |
| June 30, 2011 | \$ 43,086 | June 30, 2011 | \$ 21,871 |

The decrease in non-performing loans during the first six months of 2011 relates primarily to loans that were charged off. Of the \$21.3 million in charge offs recorded during the first six months of 2011, \$6.2 million related to two bank stock loans, \$2.7 million was on an alternative fuel plant and \$11.2 million related to six development loans.

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The following table summarizes the number and types of commercial real estate loans (the largest category of non-performing loans) that were non-performing as of the end of the three most recently completed quarters.

| <i>(Dollars in thousands)</i> Property Type | # | Principal Amount of Loans | # | Principal Amount of Loans | # | Principal Amount of Loans December 31, 2010 |
|--|----|------------------------------------|----|------------------------------------|----|--|
| | | June 30, 2011 | | March 31, 2011 | | 2010 |
| Developments/land | 6 | \$ 17,946 | 4 | \$ 10,732 | 9 | \$ 23,661 |
| Single family homes | 0 | 0 | 2 | 296 | 3 | 2,673 |
| Alternative fuel plants | 1 | 2,266 | 1 | 4,994 | 1 | 4,994 |
| Shopping centers/retail | 3 | 1,378 | 2 | 1,036 | 3 | 1,099 |
| Restaurants/bar | 1 | 654 | 1 | 614 | 1 | 635 |
| Office building | 1 | 2,950 | 2 | 3,937 | 1 | 3,675 |
| | 12 | \$ 25,194 | 12 | \$ 21,609 | 18 | \$ 36,737 |

The Company had specific reserves established against the above commercial real estate loans of \$5.7 million, \$6.9 million and \$13.3 million at June 30, 2011, March 31, 2011 and December 31, 2010, respectively. The increase in the non-performing commercial real estate loans from March 31, 2011 is due primarily to two residential development loans totaling \$3.7 million and a \$4.3 million land loan that were classified as non-performing during the quarter that were partially offset by charge offs recorded in the second quarter of 2011.

The following table summarizes the number of lending relationships and industry of commercial business loans that were non-performing as of the end of the three most recently completed quarters.

| <i>(Dollars in thousands)</i> Property Type | # | Principal Amount of Loans | # | Principal Amount of Loans | # | Principal Amount of Loans December 31, 2010 |
|--|----|------------------------------------|----|------------------------------------|----|--|
| | | June 30, 2011 | | March 31, 2011 | | 2010 |
| Construction/development/land | 4 | \$ 4,768 | 5 | \$ 6,205 | 6 | \$ 9,148 |
| Finance | 1 | 181 | 1 | 244 | 1 | 248 |
| Retail | 4 | 3,061 | 3 | 3,129 | 1 | 2,504 |
| Banking | 2 | 1,974 | 2 | 8,223 | 2 | 8,223 |
| Entertainment | 1 | 239 | 1 | 309 | 1 | 315 |
| Utilities | 1 | 4,583 | 1 | 4,598 | 1 | 4,614 |
| Restaurant | 2 | 492 | 3 | 1,121 | 4 | 1,217 |
| | 15 | \$ 15,298 | 16 | \$ 23,829 | 16 | \$ 26,269 |

The Company had specific reserves established against the above commercial business loans of \$3.5 million, \$9.3 million and \$10.7 million at June 30, 2011, March 31, 2011 and December 31, 2010, respectively. The decrease in non-performing commercial business loans from March 31, 2011 is primarily related to the charge off of

\$6.2 million in non-performing commercial business loans against previously established reserves.

Dividends

The declaration of dividends is subject to, among other things, the Company's financial condition and results of operations, the Bank's compliance with its regulatory capital requirements, tax considerations, industry standards, economic conditions, regulatory restrictions, general business practices and other factors. Under the Bank Supervisory Agreement, no dividends can be declared or paid by the Bank to the Company without prior regulatory approval. The payment of dividends by the Company is dependent upon the Company having adequate cash or other assets that can be converted to cash to pay dividends to its stockholders and, under the Company Supervisory Agreement, the Company may not declare or pay any cash dividends, or purchase or redeem any capital stock, without prior notice to, and consent of, its primary banking regulator (FRB). The Company suspended the dividend payments to common stockholders in the fourth quarter of 2008 due to the net operating losses experienced and the challenging economic environment. The Company deferred the February 15, 2011 and May 15, 2011 regular quarterly cash dividend and has determined that it will defer the August 15, 2011 regular quarterly cash dividend on the preferred stock issued to the United States Treasury Department as part of the TARP Capital Purchase Program.

Table of Contents**LIQUIDITY AND CAPITAL RESOURCES**

For the six months ended June 30, 2011, the net cash provided by operating activities was \$13.0 million. The Company collected \$80.0 million from the maturities of securities, \$1.5 million from sales of real estate, \$6.6 million from principal repayments on securities, and \$1.2 million from the redemption of FHLB stock. The Company purchased securities of \$69.0 million, purchased FHLB stock of \$17,000 and purchased premises and equipment of \$115,000. Net loans receivable decreased \$46.5 million due primarily to decreased commercial loan production. The Company had a net decrease in deposit balances of \$36.2 million (primarily in brokered deposits) and paid out \$88,000 in customer escrows. The Company also repaid \$37.5 million of borrowings.

The Company has certificates of deposits with outstanding balances of \$175.4 million that come due over the next 12 months, of which \$48.0 million were obtained from brokers. Based upon past experience, management anticipates that the majority of the non-brokered deposits will renew for another term. The Company believes that the non-brokered deposits that do not renew will be replaced with deposits from other customers or brokers. FHLB advances, Federal Reserve borrowings or proceeds from the sale of securities could also be used to replace unanticipated outflows of non-brokered deposits.

The Company has deposits of \$38.3 million in checking and money market accounts with customers that have individual balances greater than \$5.0 million. These funds may be withdrawn at any time, however, management does not anticipate that these deposits will be withdrawn from the Bank over the next twelve months. If these deposits were to be withdrawn, they would 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.

The Company has \$70.0 million of FHLB advances which mature beyond June 30, 2012 but have call features that can be exercised by the FHLB during the next 12 months. If the call features are exercised, the Company has the option of requesting any advance otherwise available to it pursuant to the Credit Policy of the FHLB. Under the Company Supervisory Agreement, the Company may not incur or issue any debt without prior notice to, and the consent of, its primary regulator (FRB). Because FHLB advances are debt of the Bank, they are not affected by the Company's restriction on incurring debt.

At June 30, 2011, the Bank had the ability to draw additional borrowings from the FHLB of \$64.2 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 \$58.1 million from the Federal Reserve Bank, based upon the loans pledged with them.

The primary source of cash for HMN is dividends from the Bank and the Bank is restricted under the Bank Supervisory Agreement from paying dividends to the Company without obtaining prior regulatory approval. At June 30, 2011, HMN had \$1.8 million in cash and other assets that could readily be turned into cash. The primary use of cash by HMN is the payment of expenses and dividends on the preferred stock issued to the United States Treasury Department as part of the TARP Capital Purchase Program. The amount of the dividend on the preferred stock accumulates at the rate of \$325,000 per quarter through February 14, 2014 and \$585,000 per quarter thereafter, if the shares of preferred stock are not redeemed. If the accumulated dividends on the preferred stock have not been paid for an aggregate of six quarterly dividend periods or more, whether or not consecutive, the number of directors of the Company automatically will be increased by two, and the holders of the preferred shares (currently the United States Treasury) will have the right to elect two directors to fill the newly created directorships. The Company deferred the February 15, 2011 and May 15, 2011 dividend payment and has determined that it will defer the August 15, 2011 payment.

The OTS (predecessor prior to July 21, 2011 to the Office of the Comptroller of the Currency (OCC), the Bank's primary banking regulator, and to the Federal Reserve Board (FRB), the Company's primary banking regulator) proposed to the Bank as its Individual Minimum Capital Requirement (IMCR) a tier 1 capital to adjusted total assets requirement of 8.5% commencing September 30, 2011, which is in excess of the Bank's tier 1 capital to adjusted total assets ratio at June 30, 2011. An IMCR requires a bank to establish and maintain levels of capital greater than those required for banks generally to be classified as well-capitalized. The Bank has submitted proposed modifications to the proposed IMCR and had discussions with the OTS related to the timing for implementation of the proposed

IMCR. However, at the time of filing of this Quarterly Report on Form 10-Q, no IMCR has been imposed on the Bank.

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HMN also serves as a source of capital, liquidity and financial support to the Bank. Based on the operating performance of the Bank or other capital demands, including potentially the proposed IMCR, HMN may need to raise additional capital. If HMN raises capital through the issuance of additional shares of common stock or other equity securities, it would dilute the ownership interests of existing stockholders and, given our current common stock trading price, would be expected to dilute the per share book value of the Company's common stock and could result in a change of control of the Company and the Bank. New investors may also have rights, preferences and privileges senior to the Company's current stockholders, which may adversely impact the Company's current stockholders. HMN's ability to raise additional capital through the issuance of equity securities, if needed, will depend on conditions in the capital markets at that time, which are outside of its control, and on the Company's financial performance. Accordingly, HMN may not be able to raise additional capital, if needed, on favorable economic terms, or other terms acceptable to it. HMN may also find it necessary to employ other alternatives to meet applicable capital requirements, including sales of assets or other forms of recapitalization, which may have the effect of reducing its base of earning assets, or diluting or changing the ownership and control of the Company and the Bank. If HMN cannot raise additional capital when needed or otherwise satisfactorily address its capital needs as they arise, the Company's ability to maintain or expand its operations, its ability to meet any Company capital plan or Bank IMCR, operate without additional regulatory or other restrictions, and its operating results, could be materially adversely affected.

Market Risk

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

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 June 30, 2011.

Other than trading portfolio

(Dollars in thousands)

| | | Market Value | | |
|---|------------|--------------|---------|---------|
| Basis point change in interest rates | -100 | 0 | +100 | +200 |
| Total market risk sensitive assets | \$ 795,488 | 784,887 | 772,983 | 758,596 |
| Total market risk sensitive liabilities | 743,960 | 733,395 | 721,342 | 709,056 |
| Off-balance sheet financial instruments | (17) | 0 | 113 | 205 |
| Net market risk | \$ 51,545 | 51,492 | 51,528 | 49,335 |
| Percentage change from current market value | 0.10% | 0.00% | 0.07% | (4.19)% |

The preceding table was prepared utilizing the following assumptions (the Model Assumptions) regarding prepayment and decay ratios that 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 from 6% to 71%, depending on the note rate and the period to maturity. Adjustable rate mortgages (ARMs) were

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assumed to prepay at annual rates of between 12% and 34%, depending on the note rate and the period to maturity. Growing equity mortgage loans were assumed to prepay at annual rates of between 8% and 45% depending on the note rate and the period to maturity. Mortgage-backed securities and collateralized mortgage obligations (CMOs) were projected to have prepayments based upon the underlying collateral securing the instrument and the related cash flow priority of the CMO tranche owned. Certificate accounts were assumed not to be withdrawn until maturity. Passbook accounts were assumed to decay at an annual rate of 21% and money market accounts were assumed to decay at an annual rate of 27%. Non-interest checking accounts were assumed to decay at an annual rate of 19% and NOW accounts were assumed to decay at an annual rate of 17%. Commercial NOW accounts and MMDA accounts were assumed to decay at annual rates of 17% and 27%, respectively. Commercial non-interest checking accounts were assumed to decay at an annual rate of 19%. 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. Certain shortcomings are inherent in the method of analysis presented in the foregoing table. The interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types of assets and liabilities may lag behind changes in market interest rates. The model assumes that the difference between the current interest rate being earned or paid compared to a treasury instrument or other interest index with a similar term to maturity (the Interest Spread) will remain constant over the interest changes disclosed in the table. Changes in Interest Spread could impact projected market value changes. Certain assets, such as ARMs, have features which restrict changes in interest rates on a short-term basis and over the life of the assets. The market value of the interest-bearing assets which are approaching their lifetime interest rate caps could be different from the values disclosed in the table. In the event of a change in interest rates, prepayment and early withdrawal levels may deviate significantly from those assumed in calculating the foregoing table. The ability of many borrowers to service their debt may decrease in the event of a substantial sustained interest rate increase.

Asset/Liability Management

The Company's management reviews the impact that changing interest rates will have on its net interest income projected for the twelve months following June 30, 2011 to determine if its current level of interest rate risk is acceptable. The following table projects the estimated annual impact on net interest income of immediate interest rate changes called rate shocks.

(Dollars in thousands)

| Rate Shock in Basis Points | Projected Change in Net Interest Income | Percentage Change |
|----------------------------|---|-------------------|
| +200 | 1,424 | 5.24% |
| +100 | 1,071 | 3.94% |
| 0 | 0 | 0.00% |
| -100 | (1,510) | (5.56)% |

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

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interest income. Management believes that the increased net interest income resulting from a mismatch in the maturity of its asset and liability portfolios can, in certain situations, provide high enough returns to justify the increased exposure to sudden and unexpected changes in interest rates.

To the extent consistent with its interest rate spread objectives, the Bank attempts to manage its interest rate risk and has taken a number of steps to structure its balance sheet in order to better match the maturities of its assets and liabilities. The Bank has primarily focused its fixed rate one-to-four family residential lending program on loans that are saleable to third parties and generally places only those fixed rate loans that meet certain risk characteristics into its loan portfolio. The Bank's commercial loan production has primarily been in adjustable rate loans while the fixed rate commercial loans placed in portfolio have been shorter-term loans, usually with maturities of five years or less, in order to manage the Company's interest rate risk exposure.

Off-Balance Sheet Arrangements

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

Item 4: Controls and Procedures

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

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

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HMN FINANCIAL, INC.
PART II OTHER INFORMATION

Item 1. Legal Proceedings.

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

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

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

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

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

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

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

Submission of a business plan by May 31, 2011, addressing strategies for supporting the Bank's risk profile, improving earnings and profitability and stress testing. The Bank's Board is to review performance no less than quarterly and report to the OCC (as successor to the OTS role as regulator of the Bank) within 45 days after the end of each calendar quarter. The plan submitted by the Company by May 31, 2011 focuses on improvement in capital levels primarily through improved earnings, reduction in non-performing assets and reduction in total assets.

Submission of a detailed written plan by March 31, 2011 to reduce the Bank's problem assets. The plan submitted by the Bank by March 31, 2011 focuses 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 focus 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 ending 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 focus on status of workout plans, classified assets, actions taken to reduce problem assets and recommended revisions to the problem asset plan.

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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 regulatory approval.

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 and the Company believes that it and the Bank are in compliance with all provisions of the Supervisory Agreements. 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.

Violations of these Supervisory Agreements may lead to more rigorous enforcement action, which could include civil money penalties, a cease and desist order or removal actions against officers and directors.

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 is not expected to have any material impact on the Supervisory Agreements as the Supervisory Agreements will now be 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.

Item 1A. Risk Factors

The Company and the Bank are subject to the restrictions and conditions of the Supervisory Agreements with the Office of the Comptroller of the Currency (OCC) and the Federal Reserve Board (FRB). Failure to comply with the Supervisory Agreements could result in enforcement actions against us, including the imposition of monetary penalties.

The Company and the Bank each entered into Supervisory Agreements effective February 22, 2011 with the Office of Thrift Supervision (OTS) (predecessor prior to July 21, 2011 to the OCC, the Bank's primary banking regulator, and to the FRB, the Company's primary banking regulator). The Supervisory Agreements supersede the memoranda of understanding between the Company and the Bank and the OTS dated December 9, 2009. In accordance with the Company's Supervisory Agreement, we submitted a two year capital plan by May 31, 2011 to the OTS upon which the FRB may make comments, and to which the FRB may require revisions. We must operate within the parameters of the final capital plan and are required to monitor and submit periodic reports on our compliance with the plan. Also under the Company's Supervisory Agreement, without the consent of the FRB, we may not incur or issue any debt, guarantee the debt of any entity, declare or pay any cash dividends or repurchase any of our capital stock, enter into any new contractual arrangement or renew or extend any existing arrangement relating to compensation or benefits with any director or executive officer, or make any golden parachute payments.

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The Bank's Supervisory Agreement with the OCC primarily relates to the Bank's financial performance and credit quality issues. In accordance with the Bank's Supervisory Agreement, the Bank submitted a two year business plan and the OCC may make comments upon, and require revisions to, such plan. The Bank must operate within the parameters of the final business plan and is required to monitor and submit periodic reports on its compliance with the plan. The Bank also submitted a problem asset reduction plan that the OCC may make comments upon, and require revisions to. The Bank must operate within the parameters of the final problem asset plan and is required to monitor and submit periodic reports on its compliance with the plan. The Bank also revised its loan modification policies and their programs for identifying, monitoring and controlling risk associated with concentrations of credit and improve its documentation of the allowance for loan and lease losses. In addition, without the consent of the OCC, the Bank may not declare or pay any cash dividends, materially increase the total assets of the Bank, enter into any new contractual arrangement or renew or extend any existing arrangement related to compensation or benefits with any directors or officer, make any golden parachute payments, or enter into any significant contracts with a third party service provider. If the Company or the Bank fails to comply with the terms of their respective agreements, the OCC or the FRB, as applicable, could take enforcement action against us, including the imposition of monetary penalties or the issuance of a cease and desist order requiring corrective action.

In addition, the OTS proposed to the Bank as its individual minimum capital requirements (IMCR) a Tier 1 capital to adjusted total assets requirement of 8.5% commencing September 30, 2011, which is in excess of the Bank's Tier 1 capital to adjusted assets ratio at June 30, 2011 and in excess of the corresponding capital ratio forecast in our capital plan at the time we would be required to be in compliance with the proposed IMCR. An IMCR can require a bank to establish and maintain levels of capital greater than those generally required for a bank to be classified as well-capitalized. The Bank has submitted proposed modifications to the proposed IMCR and held discussions with the OTS related to the timing for implementation of the proposed IMCR. At the time of filing of this Quarterly Report on Form 10-Q, no IMCR has been imposed on the Bank. There can be no assurance as to the amount or timing of any final IMCR which may be imposed.

We may be required to raise additional capital in the future, but that capital may not be available when it is needed.

We are required by federal regulatory authorities to maintain adequate levels of capital to support our operations. Based on operating performance, regulatory requirements or other capital demands, we may at some point need to raise additional capital. Pursuant to the Company's Supervisory Agreement, the Company submitted a capital plan prior to May 31, 2011 for approval by the OTS. The capital plan must include a proposed minimum tangible equity capital ratio commensurate with the Company's consolidated risk profile and projections demonstrating the Company's ability to attain and maintain such ratio. The OTS (predecessor prior to July 21, 2011 to the OCC, the Bank's current primary federal banking regulator) proposed to the Bank as its individual minimum capital requirement (IMCR) a tier 1 capital to adjusted total assets requirement of 8.5% commencing September 30, 2011, which is in excess of the Bank's tier 1 capital to adjusted total assets ratio at June 30, 2011 and in excess of the corresponding capital ratio forecast in our capital plan at the time we would be required to be in compliance with the proposed IMCR. An IMCR requires a bank to establish and maintain levels of capital greater than those required for a bank generally to be classified as well-capitalized. The Bank has submitted proposed modifications to the proposed IMCR and held discussions with the OTS related to the timing for implementation of the proposed IMCR. At the time of filing of this Quarterly Report on Form 10-Q, no IMCR has been imposed on the Bank.

Given the uncertainty surrounding the timing of the proposed IMCR and other factors, we cannot predict at this time what steps may be necessary, and whether they can be sufficient and timely, in order to address our consolidated and Bank capital requirements and comply with an IMCR. To date, we have reduced the asset size of the Bank in order to enhance its capital position. We are evaluating the feasibility of various other alternatives that may be necessary or advisable to address our capital needs and requirements.

If we find it necessary to raise capital through the issuance of additional shares of our common stock or other equity securities, it would dilute the ownership interests of existing stockholders and, given our current common stock trading price, would be expected to dilute the per share book value of our common stock, and could result in a change in control of the Company and the Bank. New investors may also have rights, preferences and privileges senior to our current stockholders which may adversely impact our current stockholders.

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Our ability to raise additional capital through the issuance of equity securities, if needed, will depend on conditions in the capital markets at that time, which are outside of our control, and on our financial performance. Accordingly, we may not be able to raise additional capital, if needed, on favorable economic terms, or other terms acceptable to us. We may also find it necessary to employ other alternatives to meet applicable capital requirements, including sales of assets or other forms of recapitalization, which may have the effect of reducing our base of earning assets, or diluting or changing the ownership and control of the Company and the Bank. If we cannot raise additional capital when needed or otherwise satisfactorily address our capital needs as they arise, our ability to maintain or expand our operations, our ability to meet any Company capital plan or Bank IMCR, operate without additional regulatory or other restrictions, and our operating results, could be materially adversely affected.

We 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 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. On July 21, 2010, the President signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act). The Dodd-Frank Act is changing the current bank regulatory structure and affecting the lending, deposit, investment, trading and operating activities of financial institutions and their holding companies. The Dodd-Frank Act requires various federal agencies to adopt a broad range of new implementing rules and regulations, and to prepare numerous studies and reports for Congress. The federal agencies are given significant discretion in drafting the implementing rules and regulations, and consequently, many of the details and much of the impact of the Dodd-Frank Act may not be known for months or years.

On July 21, 2011 (the Transition Date), Title III of the Dodd-Frank Act transferred to the Federal Reserve Board (FRB) the supervisory functions of the Office of Thrift Supervision (OTS) related to savings and loan holding companies, like the Company, and their nondepository subsidiaries.

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 will remain in effect and shall be enforceable until modified, terminated, set aside, or superseded in accordance with applicable law by the FRB, by any court of competent jurisdiction, or by operation of law. Accordingly, the Supervisory Agreement entered into by the Company with the OTS will be enforced by the FRB.

In the near future, the FRB is expected to issue a final rule to effectuate the transition of OTS regulations to the FRB. The FRB has stated the rule will include technical, nomenclature, and other changes to certain OTS regulations to accommodate the transfer of supervisory authority from the OTS to the FRB and address modifications made by the Dodd-Frank Act. In the future, the FRB is also expected to propose substantive modifications to rules impacting savings and loan holding companies in order to address other modifications made by the Dodd-Frank Act (examples include adoption of rules to implement the source of strength requirement and changes regarding holding company minimum capital levels, which have future required implementation dates). The extent and timing of any substantive changes may have an impact on the Company's capital requirements and liquidity but the effects are difficult to predict at this time.

As part of its new supervisory function for savings and loan holding companies, the FRB will begin direct oversight of the Company. 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.

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On the Transition Date, the Dodd-Frank Act transferred to the Office of the Comptroller of the Currency (OCC) the supervisory functions of the Bank s former regulator, the OTS. 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 associations will remain in effect and shall be enforceable until modified, terminated, set aside, or superseded in accordance with applicable law by the OCC, by any court of competent jurisdiction, or by operation of law. Accordingly, the Supervisory Agreement entered into by the Bank with the OTS will now be enforced by the OCC.

We do not expect that the transition of supervisory functions to the OCC and FRB to materially impact the Company, its shareholders or the Bank, but it is possible due to the change in regulators that the Company and Bank may experience qualitatively different and potentially more rigorous supervision and oversight of their activities.

Also effective on the Transition Date, a provision of the Dodd-Frank Act that eliminates the federal prohibitions on paying interest on demand deposits, thus allowing businesses to have interest bearing checking accounts. Depending on competitive responses, this significant change to existing law could have an adverse impact on the Company s interest expense.

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 to comply with laws, regulations or policies could result in sanctions by regulatory agencies, civil money penalties and/or reputational damage, 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, there can be no assurance that such violations will not occur.

Changes to federal law and regulations 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 would 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 in this Item 1.A. of this Quarterly Report on Form 10-Q beginning on page 38 for a discussion of risks related to the Company s and the Bank s Supervisory Agreements to which we have become subject and for a discussion regarding a proposed IMCR. See Part I, Item 1.A. of the Company s Annual Report on Form 10-K for the year ended December 31, 2010 for additional risk factors.

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

None.

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Item 3. Defaults Upon Senior Securities.

The Company deferred its February 15, 2011 and May 15, 2011 regular quarterly cash dividend payments on its Fixed Rate Cumulative Perpetual Preferred Stock, Series A issued to the United States Treasury Department as part of the TARP Capital Purchase Program. The Company has also determined that it will defer its August 15, 2011 dividend payment and following that deferral, the Company will have an aggregate arrearage of \$975,000 with respect to the preferred stock.

Item 4. [Removed and Reserved]

Item 5. Other Information.

None.

Item 6. Exhibits.

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

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SIGNATURES

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

HMN FINANCIAL, INC.
Registrant

Date: August 4, 2011

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

Date: August 4, 2011

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

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

| Regulation S-K Exhibit Number | Document Attached Hereto | Reference to Prior Filing or Exhibit Number Form 10-Q | Sequential Page Numbering Where Attached Exhibits Are Located in This Report |
|----------------------------------|---|--|---|
| 3.1 | Certificate of Incorporation, as amended | *1 | N/A |
| 3.2 | HMN Financial, Inc. Bylaws (as of March 22, 2011) | *2 | N/A |
| 4 | Form of Common Stock Certificate | *3 | N/A |
| 31.1 | Rule 13a-14(a)/15d-14(a) Certification of CEO | 31.1 | Filed electronically |
| 31.2 | Rule 13a-14(a)/15d-14(a) Certification of CFO | 31.2 | Filed electronically |
| 32 | Section 1350 Certification of CEO and CFO | 32 | Filed Electronically |
| 101 | Financial statements from the Quarterly Report on Form 10-Q of the Company for the period ended June 30, 2011, filed with the SEC on August 4, 2011, formatted in Extensible Business Reporting Language (XBRL); (i) the Consolidated Balance Sheet at June 30, 2011 and December 31, 2010, (ii) the Consolidated Statement of Loss for the Three Months and Six Months Ended June 30, 2011 and 2010, (iii) the Consolidated Statement of Stockholders Equity and Comprehensive Loss for the Six Month Period Ended June 30, 2011, (iv) the Consolidated Statements of Cash Flows for the Six Months Ended June 30, 2011 and 2010, and (v) Notes to Consolidated Financial Statements | 101 | Filed Electronically |

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

*2 Incorporated by reference to Exhibit 3.1 of the Company's Current Report on Form 8-K filed March 25, 2011 (File 0-24100).

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